PROCEEDINGS

OF THE FIFTH ANNUAL

Institute on Accounting

Held at

THE OHIO STATE UNIVERSITY

MAY 15 AND 16, 1942

Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

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THE BUREAU OF BUSINESS RESEARCH
COLLEGE OF COMMERCE AND ADMINISTRATION

PREFACE

On May 15 and 16, 1942, the staff of the Department of Accounting had the pleasure of welcoming members of the accounting profession to the Fifth Annual Institute on Accounting at The Ohio State University.

Registration statistics reveal that 257 people were registered at the conference. A resume of attendance by professional connection follows:

Industrial	122
Public	86
Educational	49
Total	257

It is gratifying to the department to note that in this, the first conference held since our entrance into the war, the accounting profession, despite increased drains on time and energies, considered the program of such value that attendance was close to the 1941 figure. The department is also deeply appreciative of the very busy men who appeared on the programs of the various sessions.

It is the hope of the Department that this Fifth Annual Institute on Accounting sent the accountants present back to their varied tasks with a clearer understanding and an added impetus to face the many difficult problems of the profession today.

The Department of Accounting

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FIRST SESSION

FRIDAY, MAY 15, 1942 — 10:30 A. M.
Commerce Auditorium

Chairman:

ABNER J. STARR, *C.P.A., Lybrand, Ross Brothers and Montgomery, Cincinnati; President, The Ohio Society of Certified Public Accountants*

Paper: "What's Ahead for American Business?"

DR. H. GORDON HAYES, *College of Commerce, The Ohio State University*

Paper: "What is Ahead for the Accounting Profession?"

E. L. KOHLER, *C.P.A., Editor, Accounting Review, Washington, D. C.; Administrative Consultant, War Production Board*

OPENING REMARKS

By ABNER J. STARR, *C.P.A.*,
Lybrand, Ross Bros. and Montgomery, Cincinnati;
President, The Ohio Society of Certified Public Accountants

Students, fellow practitioners and friends of the profession of accounting, it is a privilege and pleasure to welcome each and every one of you to this the Fifth Annual Institute on Accounting sponsored by The Department of Accounting, College of Commerce and Administration, The Ohio State University.

It has been my privilege to attend the four previous accounting conferences, and I consider myself fortunate indeed in having been permitted to hear so many excellent papers and discussions, to become associated and acquainted with the leaders of our profession, and to have been given an opportunity to discuss my problems with my accounting friends.

The program for this Conference has been designed to cover some of the problems brought about by this World War II. The sessions this morning will deal with the future of American business and the future prospects for the accountant; the sessions this afternoon will cover information-gathering for price control, and profit limitation; this evening you will learn about the relationship of government and business; and on Saturday morning we will have two excellent talks on the control and allocation of labor costs and expenses under abnormal conditions.

The plan for this morning provides for presentation of the talks or papers by the two speakers and then you will be given an opportunity to ask questions from the floor. May I suggest that each of you make notes during the progress of the talks so that we may have a lively discussion period.

Those responsible for the arrangement of this program have been extremely fortunate in securing speakers who are recognized leaders in their respective fields.

Our first speaker is one of the country's outstanding economists. He received his Ph.D. degree from Yale University, and after teaching at several institutions he became a member of the faculty of The Ohio State University and has been one of the mainstays of the Department of Economics for many years. He is the author of *Our Economic System* and numerous articles and papers. He has served numerous times with various Government agencies, and returned last fall from a period of service as Consumers' Counsel for the National Bituminous Coal Commission.

It is a pleasure to present Dr. H. Gordon Hayes, who will speak on the subject, "What's Ahead for American Business?" Dr. Hayes.

WHAT'S AHEAD FOR AMERICAN BUSINESS?

By Dr. H. Gordon Hayes,
College of Commerce, The Ohio State University

I

The briefest answer that I can give to the question which has been assigned to me is that there is something different ahead for business. We may all hope that it will not be very much different during any one short space of time. Certainly the idea of change is in the air. This, however, is nothing new in American history. There has never been a time during the years that white men have been on this continent that men of prophetic disposition could not declare that an age of transition was upon them. The titles of two books of about 40 years ago, *The Old Order Changeth* and *The New Era*, could have been used appropriately during any of the decades of our history.

Carl Sandburg says of the Civil War, "Death was in the air. So was birth." This was likewise true when the business men in the colonial days were struggling for a redress of grievances before the British king, and also in the early days of the 1800's when steel was displacing iron, and machinery was finally pushing toward museums the tools that had been devised long before the beginning of the Christian era. Death and birth were also in the air during the Jacksonian period, when public schools were established, when the one-man one-vote for whites carried the principles of the Declaration of Independence nearer to realization, and when plans for reforms and what we now call Utopian socialism caught the imagination of many. Similarly, in the post-Civil-War decades, when the tremendous outbursts of railroad construction and factory building meant the creation of a new economic base, and later as the small business man felt the pincers of the new goliaths of industry and through the granger movement and in the Sherman Law insisted that something be done about it, another new era was upon the American people.

The Spanish-American War was expressive of new stirrings in the consciousness of the nation and helped everyone to see that a new day had dawned. The coming of the automobile in the early years of the present century, and the formation of the United States Steel Corporation in 1901, and later consolidations, marked the new century as something different from what had gone before. Our entrance into the first World War was another new venture for us, and here we are now, deep in the most gigantic struggle of force and ideas that the world has ever seen.

But while every year, or at least every decade, in our history may be properly designated as a period of transition from accustomed to unaccustomed paths, it appears that this is unusually true of this particular time. Certainly, as the first World War took its course during 1914, 1915 and 1916, one did not hear discussions to the effect that a different economic order was in process of creation. The war was conceived to be merely another war, but today men say that a new world is being made. But just exactly what is to come cannot be foretold.

Certainly, no one, even as late as the period from 1910 to 1915, could have foretold the Russian Revolution of November, 1917. As one looks back over the history from 1915 to 1917 in Russia, it appears that the coming to power of the revolutionary group was in goodly part a matter of accidents. If this or that factor had been altered, the results might have been far different. To be sure, we can, from the vantage point of today, trace the trends that led to one-sixth of the world's surface being socialist, for history is never discontinuous, but likewise, if the Romanoffs had not fallen, and capitalism had continued in Russia, we could similarly note the sequence of events that led to that result.

Further, as one thinks of the world conflagration which Hitler has set by igniting the mass discontent of an economically weary people with fagots from his frustrated soul, one can find additional reasons for humility in prophesy. There was nothing inevitable about his coming to power. Indeed, but for the single factor of the senility of President von Hindenberg in January, 1933, the entire human race might now be following the ways of peace rather than those of war. The presidential assent to Hitler's becoming Chancellor of the Reich expressed the cunning of a band of intriguers, not the considered judgment of the hero of Tannenberg.

The course of human events, as I see it, moves in a given general direction during a given period of time, and general results can be forecast. But while we can tell our general direction, and may be correct in regard to the goal that will presently be reached, we cannot tell what fork of the road will be taken, nor what calamity may overtake us on the way. I emphasize this as a hedge against what is to follow.

II

As scholars have sought explanation for the course of past events, they have reached diverse conclusions. Thus, we have the economic, the geographical, the religious, the ideological, and even the gun theory of historical interpretation. It appears to me that we are on much safer ground if we interpret history in terms of a movement towards consistency on the part of the various elements that contribute to the totality of our institutional life.

At any one period of time, there is strong pressure to make the various elements of life consistent with each other. The economic arrangements, the political institutions, the general ideology as expressed in religious, political, and social ideals, are almost of necessity in harmony with each other at any particular period of time, or are in the process of becoming so. Thus, as we think of the days of the beginning of our national life, we find marked consistency among the almost universal self-dependent agricultural industry, the ability of an individual to protect himself and his family with his fire arms, the notion that all men are created equal and endowed with the rights of life, liberty, and the pursuit of happiness, and the dominant religious notion of the direct relationship between the individual and God. It is somewhat difficult to see how any one of these strands in our national life, with the others given, could have been different from what it was. They are all part of a single pattern. Jefferson's dictum, "the best government is the government that governs least," had its validity in each of the many facets of our national life.

Today, it seems to me, strong forces are working to make our economic arrangements consistent with the other major forces in our life. The explanation of this, as I see it, follows.

III

What are the principle aspects of our life today that affect the problem before us? I shall call attention to three items: (1) technology, (2) ideology, and (3) organization.

Technologically, as everyone knows, the face of the world has been sharply altered during the past hundred years. The general situation in respect to this is the prevalence of large-scale industries, which means that there are relatively few owners, or, more realistically, relatively few managers, and that their decisions determine the volume of production at any one time. Even such a matter as not liking the man in the White House may so influence decisions as to have a disastrous consequence on the lives of millions of persons. The new technology means also that our life is increasingly industrial rather than agricultural. The applications of science have severed ever larger portions of the population from the soil. This movement was arrested during the great depression, but has been resumed under the stimulus of war prosperity. Less than one-half of the agricultural workers of, say, 1940 was apparently sufficient to produce the entire agricultural output. Another important aspect of the new technology, which along with the second point is really a corollary of the first, is that there is now a high degree of economic interdependence as compared with the preceding decade. We are increasingly all members of one economic body, the whole of which suffers from injury to one.

The ideological situation to be noted now is of tremendous importance. One cannot well overrate the importance of the ideas in men's heads in accounting for the present, or in attempting to forecast the future. As men think, so are they. I shall make five points in respect to this aspect of our life.

First, the outlook of men today is increasingly matter of fact. This is closely related to the technological development. Veblen's idea that as folks move from agriculture to industrial work their attitudes become more matter of fact and less mystical, as a result of their having the materials with which they work more closely under control, is apparently being confirmed.

The continued presence among us of superstitions and the vogue of astrologers and other denizens of the mumbo-jumbo land indicate that the fifth decade of the twentieth century is not yet out of the woods of mysticism and into the clearing of science, but, unquestionably, we see more clearly than heretofore. Attitudes are increasingly rationalistic. This is of tremendous importance in respect to the operation of our economy. The notions that since we can build factories, we can keep them running, that since we can prevent epidemics of diseases, we can prevent mass unemployment, that instead of accepting what the fates may send, we may build our own house, help immeasurably in accomplishing these things.

Another important strand in our present thinking is the idea that it is advisable to cooperate increasingly with our fellow men rather than attempting to go it alone. This cooperation is increasingly taking the form of mutual aid through the agency of government. We have had long practice in this, as witness the public schools, public highways, and the post office. More recently, the guarantee of bank deposits and of deposits in Building and Loan Associations, the control of the stock market and of agriculture, and the social security setup, indicate a marked extension of the old idea of mutually sharing each other's burdens. The war effort marks, obviously, a great extension of this spirit of cooperation through the government. The fact, too, of our present extensive experience in government activity cannot but greatly deepen the idea in the social consciousness that other difficulties that may arise may be subjected to redress by cooperation through the government.

A third aspect in the current thinking is a strong and vigorous egalitarianism. The notion of the founding fathers of the equality of men has never been as vital a part of our thinking as it is now. The church, the school, the press, the radio and the movie have all contributed important elements in giving us the attitude that all members of our society are, of right, partakers of the bounties of our joint economic product. The four secular agencies to which attention has just been directed have, through education and advertising, greatly strengthened this notion.

The press and the radio through the advertising of goods, and the school and the movie through displaying a way of life that depends upon the goods of modern industry, have quickened the desires of those in the lower-income groups and have made them increasingly anxious to partake of the fruits of our economy. And nowhere throughout our society has it been emphasized that certain of our products may properly be used only by certain persons and not by others. Nowhere have the advertisers, either of goods or of a way of life, expressed the idea that certain persons may not have electric refrigerators, or automobiles, or plumbing, or vitamin-charged foods, or may not attend the movies. A footnote should perhaps be added that in some sections of the country there has been some prevalence of such a discriminating attitude in respect to negroes, but the impact of the war has strengthened the anti-discrimination feeling which has long been gathering strength. Certainly, in general, the fact of mass production has given us democracy in consumption such as the world has never seen. The telephone in the home of the poorest workman carries the human voice as well as does that in the palace; and the electricity, gas, and water sold to the poor are not inferior in quality to that sold to the rich. The cheapest new automobile is practically as good as any that a Vanderbilt can buy. Any young man with a week's wages may array himself in garments that make him practically indistinguishable from those who were fed with golden spoons. Indeed, even the spoons are more and more alike.

Consider in this connection our Founding Fathers, who loved the common man with a good deal of passion for that time, but who set themselves off from most of humanity with wigs, knee breeches, and silk stockings. Roosevelt and Bricker do not do that.

A fourth element in the current ideology is an increasing regard of ownership, or management, as a trusteeship for the society as a whole. In all of the discussion which has recently taken place concerning the Standard Oil Company of New Jersey not having developed the Butyl Rubber process, including the widely distributed defense by President Farish, not one word has appeared, so far as my observation has gone, to the effect that the rubber process was the private property of a private concern, to be used only as private interest dictated. The entire line of defense by the Standard officials and by others who defended them was that their conduct was in the national interest. Indeed, all the big business men who have been caught fraternizing with the Nazis have made the same excuse: it was all for the public good. This attitude, even if we somewhat doubt its sincerity, is, I submit, of great import. No longer ago than the spring of 1937 the sit-down strike in the General Motors plant was denounced on the basis of the analogy of a housemaid's barricading herself in the kitchen and refusing the family access thereto, unless her terms were met. Our thinking has changed since that time.

The fifth and last point which I shall make in respect to our general state of mind is the prevalence of a give-and-take attitude. This, indeed, is nothing new. Since the beginning of this nation, we have submitted to debate the various problems that have arisen, and on the basis of compromise have effected adjustments. Our failure to settle peacefully the slavery question is the only case in our history in which we have not followed the policy of the council chamber and the ballot box, and only a little more understanding on both sides would have enabled the democratic process to have worked in that instance.

Most fortunately we are not encumbered with the Marxian nonsense that violence is necessary in order that change may be effected. There are a few among us who peddle this social poison, but, fortunately, they are and always have been an insignificant element in our population. We have no doctrinaire position that government control, for example, is good for its own sake. We meet our problems as they arise, one by one. We do not go hunting for them.

The third important factor in the present situation is the matter of organization. We are still fortunate, as we have been since the beginning of this country, in having two political parties, and in having each of them represent a cross section of the entire nation. This has led to complaints in many quarters to the effect that the choice between he parties was merely between tweedledum and tweedledee. But this is a most fortunate situation. Under this arrangement we have made steady progress in respect to the promotion of justice and well-being, without the violent jerks in our society that might come if the parties represented sharply diverse classes.

In respect to the general organization there is, however, a new element that must be considered. This is the increasing power and strength of the labor unions. We now have something more than 10 million people in the major organizations, and it is possible that this number may be considerably extended within the next few years. This gives us an additional organizational factor that must be reckoned with in any attempt to forecast the course of business. The experience which the trade unions are having cannot but make them increasingly effective in deciding the course of industry. Particularly, their current strength makes it less probable, as indeed do many of the other factors to which attention has been called, that we shall in the future permit unemployment to reach proportions at all comparable to those which prevailed in the 1930's.

IV

All in all our present life is highly cooperative—highly collectivistic—because of the underlying technical base, the temper of the times, and the organizational means which we utilize. All these factors, as already emphasized, are mutually supplementary, but they are not wholly consistent. Business is somewhat out of line, although it has already been greatly modified. Further change may confidently be expected.

Large-scale industry, the modern corporation, and especially the holding company are, of course, all aspects of highly cooperative or collective forms of conduct. Beyond the single firm or corporation the new cooperative aspects are increasingly apparent. These are evidenced not so much by cases of compulsion, as when the public through the government requires a manufacturer to install safety devices or to deal with a trade union, but rather by instances of desire by business men themselves, as when, for example, the bituminous coal operators petition Congress to abolish the capitalistic free market in their product and substitute therefor a system of coal prices to be formulated by bureaucrats in Washington. There is an increasing amount of such legislation, both state and national, as everyone knows. Even the fair hours and wages law and state minimum-wage laws have had their sponsors among business firms. Likewise, this cooperative spirit is seen when business men join in research, in setting standards, or in eliminating price competition without the benefit of legislation. Thurman Arnold would call this last item by a different name, but however selfish it may be, the spirit is essentially cooperative, not competitive. Particularly, then, the increase in the scope and power of government in relation to business must not be interpreted as a movement by certain elements in the population against the business group as a whole, but rather as a means by which business units themselves seek the aid of the body politic. Business men, to an ever increasing degree, do not walk alone.

The significant temper of the new age, as compared with that which has prevailed heretofore, is strikingly seen in the conduct of war. Why wasn't the Civil War brought to a close sooner? Why weren't enough soldiers and sailors drafted and enough guns and mortars and gunboats made to finish the job in short order? Why were only 119,954 men drafted, and why did 73,607 of these send substitutes, leaving only a little over 46,000 drafted men to serve in the country's cause? Why did the total military expenditures for the North amount to less than $30 per year per capita? While the total number of Union troops engaged in the North was something more than two million, or almost 10 per cent of the population of the North, one must remember that many of these soldiers served for only 30 or 90 days. We got on with the job very slowly.

The explanation of this turns partly upon the small economic surplus then as compared with now. Not much could be spared for war. But the more important item was, it seems to me, the high degree of individualism which then prevailed. The men of that day were less identified with the nation as a whole, were more self-centered, were less patriotic, if you please, than are their descendants today. They were willing as a group to spend some effort, to make some sacrifice, but only a limited amount.

The total war of today is part of the present collective spirit. This spirit has been dominant in the long experience of the human race but was, as now appears, temporarily set aside during the century or two that lie just behind us.

The condition of business in this war period today contrasts sharply, of course, with that of any preceding time in the history of our country. Private ownership in business is practically gone for the duration of the war. The production of a large number of items of goods has been stopped entirely, and, through the exercise of priorities, prohibition of sales on credit, and regulation of prices, the entire economy is being channelized into an all-out war effort. Thousands of small business units, including road-side merchants of various sorts, and resort keepers, are suffering greatly, but the collective spirit which brings this about will give aid which in an earlier time would not have been forthcoming. These new regulations, it may be emphasized again, have not been so much imposed upon business as requested by business, in order that the war may be brought to a successful conclusion. We have turned almost full circle from the individualism of the late 1700's and the early 1800's to the collectivism of today.

This war experience will have lasting effects. It cannot but deepen the philosophy of cooperation which has long been under way. This will come, in part, because of the additions to the knowledge of the technique of government participation that are being made daily. Part of the philosophy of cooperation necessarily must be the faith and confidence that tasks may thus be accomplished. As experience fashions new tools and adjusts them to the hands that are to use them, they become an essential part of the philosophy of life.

In the post-war period that will immediately follow the destruction of the military power of the Germans and the Japanese, the controls which we shall have established in respect to business will not, of course, be relaxed at once. They will be retained, so far as need be, in order to bridge the gulf back from war production to production for purposes of peaceful living. Even the matter of the price controls, which are just now becoming effective, undoubtedly will be retained until our factories shall have got back to peacetime production, in order that we may avoid a disastrous price rise, such as took place in 1919 and the first part of 1920.

Business will be confronted in the post-war period with a large volume of deferred demand, because of the shortage of goods which will have developed, and, also, because of the large volume of funds which will be available as a result of the purchase of war bonds. Business will also be strengthened in that period by the need to supply food and other necessities of life to the millions of persons who will be released from the tyranny of Hitler. Another factor not to be overlooked is that we will, in the post-war period, continue the manufacture of armaments. We will not assume when this war is over that the Germans will ever after follow the ways of peace. Also, we will carry forward public works as needed to furnish employment for those who will have been released from the armed services, and from the production of military goods. We can, I am confident, expect to bridge the gulf back to the pursuits of peace with relatively little difficulty. We need merely to exercise some of the good sense and wise judgment of which we are collectively capable.

V

In indicating the probable conditions in respect to business in the long run, after the immediate post-war adjustment, one should have even more reservations than in making prophecies in respect to the short run, because of the added opportunities for the accidents of history to appear. But, at present, there is reason to believe that the degree of economic interdependence will continue to increase, even if industrial plants should become somewhat smaller. The technical advances that seem to lie ahead indicate more, rather than less, specialization. This, with the democratic elements noted above, which should certainly be expected not to become less strong, suggest further increases in the degree of cooperation. This means less autonomy on the part of individual business firms or, in other words, increased control by groups of corporations, by labor organizations, and by the people, generally, through the government.

One may expect this to mean, among other things, that restrictions upon output will be lessened, that there will be less hiding behind patents to the detriment of the public, and that payments by business both to officers and to equity owners will be more modest than the returns with which we are familiar. In short, the profit motive will be watered down. These things, and more, we can take almost as much for granted as we can the ripening of crops.

The big problem, however, is whether private business, as we have known it, can keep the conveyor belts going. Chronic unemployment and periodic mass unemployment must be avoided. If private business cannot avoid holocausts such as that of the 1930's, it is as certainly doomed as was Feudalism when a richer way of living beckoned the serfs away from the manor. And business during the 1920's, it must be remembered, made its own bed for the 1930's. New Dealers and their like had no part in this.

This dogmatism is warranted despite capitalism's having survived many periods of unemployment, for it is increasingly apparent that mass unemployment is no more excusable than are typhoid fever or smallpox epidemics. What was the matter during the 1930's? Certainly there was no reason in physical conditions for our lack of production. We were well supplied with the best equipment that man had ever seen; we had adequate raw materials; and everywhere able men and women were crying their hearts out for an opportunity to run the materials through the machines and bring forth goods for the sustenance of life. The economic ritual, the taboos, must be held responsible for the loss of $200 billion of goods and services and for the untold human suffering and degradation that resulted from the unemployment of that time. Taboos are harder to exorcise than are germs, but our conquest of epidemics should give us courage to believe that it can be done. Professor Boda has given us hope on this score by pointing out that monkeys will not starve to death in a coconut grove. We can relearn the lesson that we lost along the way.

Unemployment has been unknown during the more than 20 years of the socialistic regime in Russia, and analysis does not indicate any reason for the appearance of unemployment in any country where government ownership is dominant, nor where collective controls have been extended as far as they have in Germany, nor as far as they are here in our present war economy. Not only has unemployment become indefensible, since it is clear that only states of mind are responsible for it, but it cannot be permitted on a large scale, because of the increasing national danger, not only of revolution within but of aggression from without, when men are idle. Formerly, when one nation was thrown into depression, all other nations were in the same boat; but today with ever larger segments of the world economy innoculated against the virus of mass unemployment, national survival itself impels a people to prevent the occurrence of this malady.

The fundamental reason for depression is our dependence on the profit criterion in determining whether employment shall be provided. It comes about that the opportunity for profit declines periodically to the point that capital building is halted. This gives us idle men, increases the difficulty of producing at a profit, leads to further dismissal of employees, and so on down the tragic spiral. Another phrasing for this is that the lack of opportunity for profitable investment leads to the hoarding, or the non-use, of money, and this forces men to be idle. Economists have struggled for over a century with the problem as to why profit opportunities disappear. Weather, health, mistakes as to lines of production, inflation, speculation, rigidity of prices, of wages, and of the rate of interest have all, with other phenomena, been offered in explanation of the periodical disappearance of profit opportunities.

VI

It seems to me that the trouble lies in savings. This is an old, but very disreputable, idea. It has always been anethema to economists, churchmen, and other keepers of the country's conscience. The way to both riches and to sainthood has lain along the road of frugal living. The saver, and not the wastrel, has been the ideal held before the youth. And savings, as anyone can see, built the railroads, steel mills, and automobile plants. Without saving, man would still be chasing rabbits naked and catching them by hand, when he was lucky. Even so, I feel that good old savings bring on unemployment. This, too, if I understand him, is Keynes' position in his *General Theory*, the most talked about and most influential book in economics ever to be written by a school man.

The matter is, I believe, easily demonstrable, even in the few minutes at my disposal now, although well-trained accountants with a minor in economics could not be expected to accept it wholeheartedly at once, and especially not if they had economics as a major. It will have to ripen in the wood. The analysis is, simply, that the whole capitalistic spirit and the religious ethic stress the importance of saving. Persons with large incomes will not spend what they have available. In 1929, it should be recalled, the upper 3 per cent of the income receivers had, according to the Brookings

Institution, more than 33 per cent of the total money income of the nation. This was before taxes. After taxes, the upper 3 per cent had an even larger proportion. The concentration of income has not been so marked since, but distribution is, and always has been, most unequal, as everyone knows, and this, in this age, has meant large savings.

Not only have the upper-bracket people wished to save and really been compelled to do so, but persons in all the lower-income groups have felt the need to save in this uncertain world. This has resulted not only in what we may call original saving, but also in the saving of the income from savings. This means the compounding of savings. It means accumulation at compound interest. This is impossible in a finite world. Attempts to do this could not but bring a collapse such as has occurred periodically throughout the life of capitalism.

The well-known computation that a penny put at 5 per cent interest to compound at the time of Jesus, would by now amount to a sum equal to the value of a ball of gold the size of the earth, at the pre-Roosevelt gold price, shows the absurdity of trying to build a continuing economy on such a foundation. Compounding is impossible in this finite world, whether it be of savings, or animal or vegetable life. Death is necessary and inevitable among things that procreate, and so is bankruptcy in an economy based on the practice of saving the income from savings. Prosperity, however, does not need to wait upon bankruptcy in order to turn into depression, for merely the portents of bankruptcy—an unfavorable outlook for a continued increase of sales, after the compounding has continued for a few years—is sufficient to halt investment, create unemployment, and force bankruptcy throughout the system. After enough of the weaker ones have been killed off—after the claims of savers to income have been so reduced that savings are greatly curtailed—the society can go forward on another attempt to do the impossible, particularly if it is lucky enough to have inventors come along with plans for low-cost production that will induce investment and thus draw idle money out of hoards and idle men away from the relief line.

This brief sketch, which is so brief that perhaps I should not have introduced it at all, helps to explain a great many things; that is, the propensity to save the income from savings—the insistence of savers on having more and more factories and their refusal to buy more than a few of the goods that come out of these factories—helps us to see why there is such tremendous pressure in our society to sell. To be sure, sellers of goods may be expected to try to set their prices at the buyers' resistance point, thus making sales difficult; but this is not sufficient, it seems to me, to account for the selling pressure that is so characteristic of our economy. The fact is that the poorest 90 per cent of the people, with, say, 70 per cent of the national income, are constantly being pressed to buy more than 70 per cent of the product. As recovery follows depression, they can do this with the help of credit. This is the prosperity phase of the cycle. But soon the credit limit is reached, and *that* honeymoon is over.

The chronic market impasse, which culminates in periodic depressions, also helps us to understand the pressure to sell abroad and not to buy abroad, or why a protective tariff has always been a major part of national policy under capitalism, despite the beautiful logic to the contrary which the economists built on a false major premise. England's free-trade policy, it should be noted, fell in that unusual period when she had such a jump on the other nations that she was in no danger of having to accept imports equal to the goods and services sent out. She was, without a tariff, able to get other nations to take the goods to which her savers were entitled, but which they would not take and which the poorer groups could not buy. As the other nations caught up, England's tariff went up.

The market impasse which comes from attempting to save the income from savings also helps us to understand why we benefit from calamities such as fires and floods and why our economy functioned so splendidly in 1941. During that year we produced more than $13 billion of war goods, including lend-lease materials, and put a million and a half men under arms and yet closed the year better provided with food, clothing, housing, automobiles, cigarettes, candy, books, entertainment, and Christmas presents than ever before, despite still having four million workers unemployed. We were spending our way to prosperity, despite the doctrine of otherwise sensible men that that cannot be done. We were showing ourselves what our economy could do if the market jam could be kept broken. It was broken because men had received $13 billion for producing things that were not for sale. Buying power exceeded goods for sale. If it had not been necessary to increase greatly our war effort, we could verily have spent our way to the economic heaven of well being, if the war would have lasted long enough.

VII

If the major economic difficulty is, as it has been stated here, that the propensity to save the income from savings gives us a chronic condition of under-utilization of men and equipment, which is alleviated only occasionally when the luck of new inventions makes large investments profitable and when installment sales and other forms of consumer credit including loans make possible a period of prosperity but carries us inexorably toward depression, there are certain lines of procedure that recommend themselves.

(1) Taxes should be heavy enough upon large-income receivers, and upon corporations, to siphon into the hands of the government a large portion of the funds that would otherwise be saved. The present heavy taxes should be continued in the post-war period. Care must be taken that these sums are not paid back at once to the large-income receivers through the redemption of government bonds, but the bonds of the small-saving group should be redeemed in as continuous a stream as possible. The tax funds received should also be used in the purchase of food for the sub-standard groups, in providing generously for medical and dental care for the poor who need it, and in carrying forward various educational and cultural programs. This is, in large part, merely an extension of present practices.

(2) The general principle of collective social security should be so extended that the need for individual savings to guard against the proverbial rainy day will be greatly reduced. We have already traveled far along this road of mutually bearing each other's burdens which our ancestors entered on in their first fire and life insurance ventures.

(3) The planning mechanism that we already have, such as the National Resources Planning Board, the appropriate section of the War Production Board, and the Reconstruction Finance Corporation, should be charged with increasing responsibility for determining the lines of investment that the country as a whole is to follow. All proposals for investment beyond a designated sum should have to be cleared through the national planning council. Approved projects could be financed with funds that the sponsors would otherwise have paid in taxes or by government funds derived from taxation. We have already had considerable experience in this, particularly in relation to the present war effort.

(4) Projects financed with government funds should be operated by private enterprise, under lease agreements, such as is now being done in many fields of war production.

(5) When new and more efficient projects are launched, the government should subsidize the firms put at a competitive disadvantage; or it should buy them out and close the plants, rather than permit the slow lingering death which has been the concomitant of progress throughout our history. There will no longer be need for bankruptcy if the savings difficulty is solved.

From some such a program, we can, I believe, make our investment more orderly and less wasteful than ever before, make more possible the utilization of our industrial capacity, or in other words, approach nearer to continuous full employment, and eliminate depressions. We would thus be accomplishing the long-sought-for results, not by any radical alteration in our practice but merely by the extensions of devices to which we are well accustomed.

Business, to be sure, would be altered somewhat; but this, too, would not be anything new in our history. Business leadership would continue to serve us as in the past, but it would serve us better. Economic incentives would still prevail, and, with the elimination of the log jam of too many goods trying to get through too narrow a stream of buying power, American business men would really be able to lead us into the land of economic plenty and security.

The times are portentous. The generative power of the new production techniques will not be denied. The sons of men will not continue to live placidly in poverty and insecurity. The scourge of war and the threat of revolution cannot be allayed until a better economic life is provided. We cannot go back; we can only go forward. With pride in the achievements throughout our century and a half of history of democratically adjusting practices to new conditions, we can with confidence meet the present challenge, although it exceeds in gravity any which men now living have ever experienced. To paraphrase Brandeis, 'we shall guide by the light of reason; we shall let our minds be bold.'

CHAIRMAN STARR: Dr. Hayes, I am sure that this applause demonstrates very forcibly what the audience thinks of your excellent, thought-provoking paper, and I am sure that we shall have many questions for you during the discussion period.

The next speaker on our program is from the University of Michigan. I think, perhaps, that having one of the speakers on the program this morning from Michigan might be in the nature of an appeasement program for the football game of this fall.

This expert is an exception. He has devoted some time to teaching and has written several textbooks on accounting. Several years ago he gave up his public accounting practice in Chicago to go with the Tennessee Valley Authority. Some months ago he left that position to go with the War Production Board, in Washington, as Advisory Consultant. For many years he has served as Editor of *The Accounting Review*, and he will have a very influential part in drafting the various tentative statements in accounting policy advanced by the American Accounting Association.

Our speaker has always been known as a man whose thinking was several years ahead of current practice. He will talk to you on "What Is Ahead for the Accounting Profession?" It's a pleasure to present Mr. E. L. Kohler, Editor, *The Accounting Review*.

WHAT IS AHEAD FOR THE ACCOUNTING PROFESSION?

By E. L. Kohler, *Editor,*
The Accounting Review, Washington, D. C.; Administrative Consultant,
War Production Board

I feel influenced by the last speaker to remark that what I have to say is by no means of the degree of importance as the items of which he spoke to us. I can't compete with that stimulating paper of his. However, I should like to relate what I have to say to a remark that he made at the outset of his paper, when he mentioned that Veblen had commented on the change of attitude on the part of people as our economy became more industrial in character and less agricultural—namely, a decline of the mysticism that has somehow always plagued the human race, and an increased matter-of-fact attitude. When applied to the field of accounting, particularly auditing, I think that attitude is rather easy to trace.

Practically all of what I have to say today can go under that segment of the previous speaker's outline of the things that we face immediately, because we of the accounting profession have with us most of the problems Dr. Hayes has presented, or will have them before we get through with the present national emergency.

The heavy hand of war has fallen on professional accountants. It has brought to them new responsibilities, new liabilities also, and I earnestly hope, as I know you do, that they will not be remiss in meeting them. I refer of course to new work loads, accompanied by rapidly dwindling staffs. A number of professional accountants have urged group action in requesting deferment of staff members who have attained a certain rank, just as business enterprises, deemed by them to be no more essential to the war program, have moved to defer industrial employees needed to maintain the operating effectiveness of manufacturing plants. Other accountants have resorted to the use of unskilled help and to the institution of programs for rapid training, designed to offset at least in part the dangers attendant on such a program. Others have curtailed their audit programs or have refused to undertake new assignments.

In suggesting to my fellow accountants that they take the utmost advantage of their present opportunities, I hope I shall not be accused of wanting them to profit unduly in an emergency as grave and portentious as the one we are now in. Accounting is said to have been the only profession that profited by the last war, not so much because of the increased emoluments of its members, but from the greatly increased recognition of the necessity of the services that accountants render. The effects of that recognition were lasting and may still be measured, and the same thing can happen again. However, I refer to something of greater social significance: the ability of the accountant to spread his needed services more thinly without any major loss in effectiveness. That this is now a prime necessity is something that has been forced home on many of us. In the time allotted me on this program I want to examine with you a number of possibilities in this direction.

The draft, along with the increased need for accountants in war industries, has depleted the staffs of many firms to what appears to be an impossibly low level. The past season has been a nightmare to the profession and the most difficult period the profession has ever weathered. Yet, next year it will be still more difficult, for the needs of the armed services will have increased greatly and the present scale of exemptions, undoubtedly, will have to be lowered. It is almost imperative, therefore, that constructive effort be devoted immediately to the problem of carrying on the work of the profession and maintaining its high standards of performance by the adoption of methods designed to make the greatest possible use of the professional skill that remains available.

Under the pressure of war conditions, no changes can be expected in the character of the coverage in annual engagements. Annual balance-sheet audits, following the pattern of the Committee on Audit Procedure, of the American Institute of Accountants, will still be in demand and will, within limits, be supplied. And in accordance with those standards a detailed audit of the transactions over a limited portion of any one year will ordinarily be regarded as essential. Nevertheless, an important amount of time can be saved by the adoption of a number of expedients. They deserve to be examined carefully.

First, in view of the fact that the younger and less experienced members of the profession will not be in the picture, dependence must be had on an older, more experienced staff. But even if the detailed-audit portion of the engagement be eliminated, these older staff members must still spread themselves thinner. The first expedient that comes to mind relates to working papers. Much time can be saved if they are reduced to the absolute minimum. Previously unthought-of savings in time will suggest themselves by combing over the previous season's working papers for the purpose of eliminating nonessential analyses and operations. It is quite possible that many of you have done this in individual instances. In ordinary times the trend, as everyone knows, is to do no less than was done last year. Perhaps one of the firm's principals years ago asked for the analysis of a certain account and a member of the staff was sent back to the job, already concluded, it was thought, in order to secure the additional information. Almost every junior accountant, and certainly all of you who have reached or passed the senior stage, knows what this means. The thing to do now is to ask: Is this schedule necessary any longer? What purpose can it possibly serve now? Why not eliminate it entirely? A good set of working papers, like the ideal short story, should contain no element that does not lead directly to the conclusion. Useless working papers should be cut out anyway; and there is no time like the present to make strenuous efforts to see that none are prepared in the future, and that even slightly informative papers be reduced in number, certainly in detail, if not excised completely.

Many accountants feel compelled to analyze certain accounts for purposes of continuing a long-continued story carefully developed over a period of years. By way of example, I might cite an argument, in which I had a hand years ago, over the bad-debt reserve of a large retail establishment. The books were so kept that the analysis was a truly monumental job. It involved not only references to original entries but to the accounts written off in a half-dozen offices. Careful digging by a senior and a junior would yield the desired results, but it took two weeks of continuous work. The analyses had been beautifully done in the past and a good deal of satisfaction must have been experienced when a summary prepared from an inch-thick sheaf of papers was found to tie in perfectly with a predetermined total. But inquiry revealed two things: First, that once the summary had been perfected, no one reviewed or obtained any information from the detail; and second, that a summary of the debits and credits in the reserve had been prepared regularly in the client's credit department, which, with a couple of hours' test-checking and summarization, would have served any possible audit purpose.

This illustration suggests two other injunctions: (1) Make the maximum use of the client's routine analyses and summaries, and (2) have the client's accounting staff prepare regular and special analyses. Careful attention to this possibility has yielded remarkable savings in time. In fact, carried to the extreme, it would be possible to have the client prepare all the working papers, including the worksheets supporting the financial statements, leaving to the outside auditor only a review and testing of the papers handed him. Some of you may be familiar with instances in which this procedure is followed. It is quite common, of course, to have limited sections of the papers prepared by the client's staff, especially detailed analyses of certain accounts, and summaries and analyses of branch-office accounts. But the ordinary procedures in this connection deserve careful restudy in most cases; the auditor, upon review, will find agreeably surprising savings in the time of his staff.

I know that some firms regard any material aid by the client's staff as an improper shifting of responsibility. The work of the auditor cannot be reduced to the level of a checker and inspector, they say; under such conditions he cannot see how accounts function, and when he examines summaries only he may fail to observe generic sorts of *mistakes* in accounts. Erroneous *methods* of keeping accounts may be missed entirely. However, I have been unable to sympathize with this point of view, emergency or no emergency. When pressed for details, some accountants will cite horrible examples; but upon dissection these, as a rule, have been found to reflect no intelligent review of the work prepared by others. A part of the answer to this rigidity of attitude can be found by observing the detail work done by the average none-too-skilled junior. He may prepare reams of work-sheets and miss all the points. But in no case can the absence of a sensible review of the work done be excused. I should greatly prefer seeing accountants strengthen their approach to the whole review problem with this lesson of experience in mind: That a wise review by an accountant of long standing is worth many times the analytical work of an unsophisticated assistant.

I am afraid, too, that some of the reticence on the part of auditors to accept the work of others can be found to lie in the need that they feel to retain an aura of mystery over their work. A part of this they have inherited from their predecessors, who used to be employed only where cash shortages had occurred and confidential investigations had to be made. Another part of it has been retained even by the most self-searching, self-critical auditors. They feel that a goodly share of the value of an outside auditor lies in the very lack of knowledge by a client's staff of what he is doing. If that staff feels that its every act is not likely to be probed by an auditor, or is to be probed by an auditor no longer mysterious, a restraining influence of great value to the client will have been irretrievably lost. To me this is a most unfortunate viewpoint. I would much rather see this type of auditor working constantly to improve his examining methodology to the end that keen observation and insistence on a strict system of internal controls be established as a more-than-adequate substitute. As a matter of fact, the wrong-doer has more to fear from an intelligent auditor whose methods are openly known by the client's staff, for he knows that one who deliberately mystifies others is himself easily misled.

A closely allied problem to which inadequate attention has been paid by auditors is the maintenance in the client's office, as the result of regular procedures of the client, of papers, analyses, and records which, where questions arise, are as available as the auditor's own worksheets. Why carry away, by an elaborate process of copying, details that will be by no means as important as the original records themselves? Of course the obvious answer is that a certain minimum build-up of papers is essential to the independent conclusion so vital to an accountant's certificate. Lawyers will suggest the absence of evidential data in scanty working papers. Some accounting firms have spent long hours with their attorneys in discussing and then establishing minimum file requirements. But the exigencies of the present situation require a greater degree of realism than some of these early discussions with which I am acquainted have revealed. The possibilities here are very great; they demand more time than I can give them here. Further explorations and a fresh slant on the need for and the character of audit evidence are essential.

One important method of reducing audit time lies in the further development of the permanent file. This device has not been covered in textbooks on auditing, but it has become thoroughly established in the audit procedures of many firms. Essentially, the permanent file is an aggregate of working papers covering items of continuing interest. Built up over a period of successive audits, the permanent file and the working papers having primary value only in the current audit together constitute the accountant's record behind his published results. Ordinarily, the permanent file consists of sections in which are gathered summaries of capital stock, each surplus and surplus-reserve account, dividend records, funded debt and debt-discount accounts, a fixed-asset and depreciation history and tabulation, organization charts, official personnel, minutes, and other matters reflecting background and performance which will serve as a substantial added basis for the auditor's present conclusions and as an aid and time-saver for the members of his staff charged with responsibility for future audits.

In some instances the permanent file serves as a sort of a general ledger to which are posted at leisure certain details of the current working papers. In these cases the file is usually not permitted to leave the office, and it has value primarily as a case history, not as a time-saver for the field staff. Elsewhere the current file is required to be complete, with respect to such items as capital stock, in order to satisfy the auditor's conviction that each adult record be completely self-contained. In both situations, a little relaxation of the auditor's rigid attitude will be found to be extremely helpful in the present emergency. Let the current file and the permanent file be taken together as the audit record for the current year; under such a plan no current papers would appear on capital stock if that account remained unchanged during the audit period, except perhaps some comment indicating the method by which the auditor has satisfied himself that, in fact, no change has occurred.

At this point I should like to suggest another topic for detailed investigation: the substitution, in working papers, of more narrative for tabular material. I do not mean to suggest tedious discourses on systems of internal controls or elaborate treatises on such things as the form and filing of cash records, but the use of brief descriptive material showing the client's method of compilation, particularly operating peculiarities and deviations from standard practices, which the auditor has observed, and some measure of their effect on final results.

The study of and the auditor's dependence on methods of internal control have long been emphasized but not as fully as they deserve. By insisting on rather than mildly suggesting the adoption of stricter methods of internal control, the auditor can save himself much future work. He can also suggest and participate in establishing improved work programs for the client's internal-audit staff, and even provide for his receiving extra copies of their reports. A review of these reports and occasional talks during the year with the client's audit staff may be a fully adequate substitute for the customary detailed-audit portion of the annual audit and will strengthen the arm's-length attitude which such a staff should adopt towards the organizational units they examine. Moreover, the internal-audit staff can be extremely useful during the audit period, and its studies, observations, and reports at the year's close can be made to dovetail with the outside auditor's work so as to minimize the latter's time on the job.

Finally, I want to suggest a field by no means fully explored, but one which has been gradually developing over the past ten years. This is what has been called, for want of a better name, the procedural audit. The procedural-audit area is a fascinating one and I believe it can and should be made a most useful and essential part of every audit engagement, even in normal times. The bane of an employing auditor's life, as everyone knows, is the offseason period when he must seriously curtail his staff. Why cannot the auditor have, instead of a swollen staff at the peak season, the same staff throughout the year? The answer usually given is that the natural business year needs wider adoption, or that everyone wants their reports too promptly after December 31. A better answer is that no one apparently has figured out a way of spreading the work over the calendar year. The procedural audit, however, once its value is established, can do much to spread the work.

I should like to distinguish here between what I am calling a procedural audit and the ordinary type of interim audit. I am suggesting the partial substitution at least of the one for the other. Interim audits are of course common enough; they are offseason examinations of accounts, often cash, inventories, changes in classification, the basis for quarterly statements, inquiries into methods of internal check, frequently system work. These checks may serve to reduce the detailed-audit work at the end of the year and may be of value to the client, especially where internal audits are limited.

In contrast to an interim-audit, a procedural audit is in effect a searching examination into the system of internal controls of a business enterprise. By the term "system of internal controls," however, is meant something more than what is found under that heading in an auditing textbook. The examination is one of the business as a whole: its organizational pattern, its operational methods, the ways in which its business policies are established and enforced, the nature of its top-staff organization and the methods by which the top staff is interrelated with and controls the work of the rank and file of the organization, the means of delegating authority and the success attending such delegation, internal and external reporting practices, and so on through the gamut of observations of how the business is conducted. The object to be obtained is not a knowledge of the organization for its own sake, but in its relation to the significance of the accounts. Of course it is no more than trite to say that a business may be observed through its accounts since every operation is fundamentally designed to be relected for better (in the ruthless-profit days) or for worse (in these latter socially minded days) in the profit-and-loss account. But accountants have not so readily embraced a necessary corollary to this proposition: that it is the organization that makes the accounts which reflect the organization. If an auditor knew precisely how the accounts had been built up and maintained, and could somehow satisfy himself through a knowledge gained by other than ordinary audit procedures of the accuracy of the accounts, his audit work would be simple indeed. The procedural audit offers at least a partial solution. Undertaken during the summer season by the senior staff, the procedural audit builds up over the years a surprisingly precise knowledge of how the business functions and what the weak points are; it makes the accounts and financial statements much more credible and revealing documents, even before the formal balance-sheet audit, and sharpens the need, if any, for report qualifications. It makes unnecessary extensive reviews of procedures and organizational relationships at the end of the year, and gives practical assurance on many points that so often clutter up working papers and take the auditor's time while the annual audit is going on. At the same time, the auditor has established for himself a larger sphere of activity, from which, I know, many of the profession would now shrink. But the plain fact is that the financial statements to which the auditor subscribes, with or without qualifications, can be no more than the story of a good, middling, or bad organization which he is trying to portray to third persons. The larger field is in fact already his.

That concludes my formal remarks, but I would add one more point. That point is this: looking forward to the future of accounting, nothing is more important than the need for attention by professional accountants to matters of government. Most accountants lean heavily in the other direction—away from government—but the last speaker has emphasized with a great deal of force that government and business cannot remain in the same detached, carefree relation to each other that they have maintained in the past.

Certainly we have a very natural relation with government and business. At the present time the organization with which I am now associated is dealing in thousands and tens of thousands of transactions each day with private business, trying to keep private business going, trying to speed up private business in furthering the war effort. That work, in itself, is opening up a vast new field of possible future relationship between government and business, perhaps on an entirely different basis than has heretofore been conceived. As I look at it, that development can be, to a great extent, in the hands of accountants, because I have always felt that accountants, through their ways of exploring the field in which they have more than a speaking acquaintance, have made use of techniques (and undoubtedly will, in the future, continue to develop those techniques to a higher degree) that make for the translation of the very formidable and difficult into something that is lucid and understandable by the common person.

I think that at the present time one of the difficulties of our government—I mean not only the Federal Government but also state and local governments—is that the nature of its operations can't be understood by the average individual without a lot of hard work on his part. Methods of organization such as the City-Manager plan, of course, do make the operations of government more observable than they otherwise would be, and to the extent that that plan or a similar plan can be developed in other governmental fields the plans of government and the methods by which it operates would be more understandable.

The accountant has found, as a result of long experience, that the more open a corporation's accounts have been, the more they have been exposed to the public view, the more they have been investigated, then the more likely the corporation's officials have a heightened sense of their social obligations. This has been more and more apparent during the last few years.

Why shouldn't the same reasoning apply to government? It does; and one of the great difficulties with government at the present time is its accounting. An adequate system of accounting either does not exist or it exists in such a form that it does not lend itself to results that can be interpreted by enough people. One of the worst offenders in this respect is the Federal Government. There has been a lot of talk in recent years and quite a few articles have been written on the subject of governmental financial statements. The Bureau of the Budget has been charged with an order, and the Treasury has been charged with the responsibility of developing over-all financial statements for the Federal Government.

One of the Assistant Secretaries of the Treasury, about a year ago, told me that one day he was wandering around the main Treasury Building in Washington and happened to go down in the basement. On the ground floor he found about sixty people, who had been working there for years without, apparently, any knowledge on the part of the executives of the department as to precisely what they were doing. He made inquiry there and found that what they were trying to do was to develop a Federal balance sheet, and that they had been working for over ten years on the problem. However, his knowledge of accounting was not great enough to enable him to answer the question I immediately asked—whether they were preparing a balance sheet ten years old, or whether they were working on methods by which balance sheets could be prepared some time in the future. I never have been able to find out what that group had accomplished. It may still be there for all I know.

But if you will examine such statements as are extant on Federal-Government operations and Federal-Government financial position, you will find this sort of thing: the only regularly issued financial statements are in the budget documents submitted once a year to the Bureau of the Budget. It seems absurd, of course, that financial statements should only appear when the government bureaus and departments are asking for more funds. You will also find that nothing approaching a Federal balance sheet is anywhere near in sight at the present time. It is not possible to develop such a thing at the moment.

Now it is true that the Treasury issues a daily report of cash on hand and other related items; it is true also that Treasury reports every month on the government's financial position show the combined balance sheets and operating results of Federal corporations. There are some fifty corporations whose assets and operating statements are combined into a single conglomerate statement, but none of the interdepartmental items are cast out in the process, so that you have only a grossing of the assets and a grossing of liabilities, and, of course, duplication on both sides as a result, with some of these items running into the billions.

In 1937, in his annual report, the Comptroller General of the United States prepared a balance sheet. Those of you who happen by some accident to follow *The Accounting Review* will probably recall some sour remarks that I made there regarding that balance sheet shortly after its appearance. It was a most atrocious misleading statement, showing on the one side certain items of cash, and containing no receivables except those that had fallen into the possession of the Comptroller General, and probably were worthless, because he never gets hold of accounts receivable until they have been regarded as bad by the various agencies. On the other side of the statement was the funded debt of the United States, none of the nonfunded debt at all—that was not even mentioned—and no other current liabilities except certain items under the direct control of the Comptroller General. And what do you suppose the difference between the liabilities and the assets was called? National deficit of the United States, without any qualifications! Under that scheme of accounting—or juggling, for it was not really accounting since the items were picked from various sources and were not under any common control—you would get more liabilities than you would assets. If you don't include fixed-asset items in a balance sheet, if you omit the thousands of other things the Federal Government possesses, the principal item on the balance sheet will be funded debt; and in that particular case, of course, there was an excess of liabilities over assets which was called the National Deficit for the year 1937!

That was the only balance sheet of the Federal government for that year, and none has been produced since—by the Comptroller General or anyone else.

Now, it may follow, by a logic that is by no means as abtruse as it might seem, that as accountants become interested in governmental affairs, the clearer and more sensible governmental operations will become. I think there is a direct relationship. What is needed at the present time is the same kind of analysis showing what is happening in the Federal Government's operations as has been so necessary in the affairs of private business.

Just how to attain that desirable state of affairs, I haven't the slightest idea; I don't know what the program should be, but certainly it will come about in some way, some time.

Right now accountants can do no more important a job, especially in an emergency like this, than to demand clearer statements of governmental operations and, at the same time, to be equally insistent upon better performance on the part of governmental agencies. The one cannot be accomplished without the other.

CHAIRMAN STARR: Mr. Kohler, your comments certainly were most vital to the practicing accountant, and we appreciate greatly the suggestions that you have given us.

For the next twenty minutes we will have a discussion period. The period will not be limited to questions but will also include any comments that any of you care to make.

DISCUSSION

MR. VICTOR H. STEMPF (Touche, Niven & Co., New York): If I may deal first with those things about which I presume to know a little, I should like to offer a few comments on Professor Kohler's statements about our auditing procedures during these difficult times. What he referred to as "procedural auditing" I think would be more commonly understood by most practicing accountants as interim-examination, which naturally is procedural in character, because it deals with accounts at interim periods of the year, rather than with specific balances which appear in the financial statements at the year end.

I think that that principle is well recognized by the Institute's Committee on Auditing Procedure. It is one of their definite recommendations.

The major problem in these times is naturally going to be inventories. Certainly in those industries involved in war production, inventory is the one big problem; and there our main objective should be more and more to bring about effective, reliable, perpetual inventory control, subjected to what I choose to call staggered count, or stagger test, throughout the year. This means that when the year end comes around we may eliminate completely, so far as the company is concerned, a complete physical inventory and, so far as the auditor is concerned, anything which deals with test counts or observation of inventories at that date, all of that having been done through the year.

If corporations are so set up that they have internal auditing staffs of their own that are doing the staggered testing and adjusting of inventories throughout the year, then the independent auditor's job should be to have its representatives accompany those internal auditors and to observe the work which is being done and to challenge items themselves, if they deem it necessary to do so. Thereby, it will be possible to build up throughout the year an impression which we hope will indicate that the company's representations concerning inventory at the end of the year are definitely credible and acceptable.

Mr. Kohler made a correct statement, insofar as the Institute's Committee is concerned, when he said that there shall be no let-down in the standards of examination, that work which is done must be well done. It may be necessary to reject work, to do fewer audits. In these times that selection naturally must be based upon doing those audits which relate to the war effort. The work being done must be well done, whatever its character, but there are one or two other factors which may expedite our work.

Reference was made to the natural business year. We know for a fact that the Treasury Department reports that for the year 1940 some 35,000 additional taxpayers filed on a fiscal-year basis. I think that is an encouraging transition. It is piling up each year.

The Institute's Committee on Auditing Procedure, the Institute's Committee on Public Information, the New York Stock Exchange, and the S. E. C. are all going to do what they can to persuade clients, taxpayers, and reporting corporations to adopt their natural business years. The S. E. C. has been importuned to grant extensions of time within which to file 10-K reports, extensions of say 120 or 80 days with respect to listed companies; the Stock Exchanges have been asked to suggest to corporations that annual meetings be deferred, postponed, or adjourned, and that the requirements for the issuance of financial statements 20 days before the annual meeting shall relate to the adjourned meeting dates, rather than to the official annual meeting dates.

Various devices of that kind will enable some spreading of the work.

Then one more point which I should like to clarify a bit, if Mr. Kohler will forgive me. He referred to the external auditors *accepting* data prepared by the client. I think he lent an implication which he did not intend. I think that it is fundamental that the relationship of the independent auditor and his client be such that the independent auditor accepts nothing—he receives everything and he assays, tests, samples, checks any material which is presented to him, to satisfy himself that the representations are acceptable and reasonably accurate, but he does not permit the client's staff to prepare for him something which he automatically includes in his own conclusions.

I think that we should extend to a maximum degree the preparation by the client of clerical data from which the checking is done. The corporation, as Mr. Kohler suggested, might well prepare a complete set of papers, but that does not mean doing the audit for the independent accountant; it is simply preparing the media which will expedite the work of the audit. The material is then subjected to such testing as the auditor in his discretion considers necessary and desirable to satisfy himself that the company's representation may be relied upon.

And then, if I may be pardoned, Dr. Hayes, I should like to mow a little hay. I remember three statements that you made, that impressed me particularly; one was the reference to the Jeffersonian policy that that government is best which governs least; the second, that monkeys will not permit themselves to starve in a coconut grove; and the third, your conclusion, which I should refer to as a soft Utopian dream.

I think that we have to reconcile those first two. That is the job for the post-war period, undoubtedly. I am still a staunch believer in rugged individualism and free enterprise, and the greater the degree to which we can return to it, the better, and I think the Jefferson philosophy supported that idea. Then, that we cannot permit monkeys—or people—to starve amidst plenty is a foregone conclusion and is one of the flaws and errors in our ways during the last fifty years, at least in our country, and that situation must be corrected; and to the degree that we require government policing to prevent that, I am fully in accord that such government policing should be provided.

I disagree with the inference that I drew from your statement, and which also may be drawn from Stuart Chase's recent book, *The Road We Are Traveling*, from which I think I could quote directly; he says that 'if at the conclusion of the last war we were unable to retreat to free enterprise, when the victors themselves desired it, how will it be humanly possible to do so at the conclusion of this war? I doubt it; it is a closed book.'

I resent that word, "retreat." It is not a matter of retreating—it is a matter of retaining the things that are good in free enterprise and in our American way of life, which have enabled the marvelous development and increased national wealth and prosperity and improved standard of living of the general average of our people since this country of ours was founded.

I think the good things that have evolved out of the system of free enterprise in that period should be retained to the fullest extent. We should not cast them overboard, and I think that one of the principal emotional factors—and I noticed that both of the previous speakers used emotional words—was the very fact that a man had to work for what he got out of life. I think that when you provide a soft, Utopian plan, under which a man may do or not do what his conscience and his fellowmen demand of him, we are bound to step backward. We need some incentive, some compulsion, something that drives us to do a job, and I think that free enterprise has given us that compulsion. The minute you remove completely the profit motive, or reduce it to such an insignificant factor that it lends no attraction, you are taking away the most important driving influence that has brought new development, new discovery, new enterprise, new risk in our American way of life.

Stuart Chase makes another statement in his book, a rather scanty admission on his part, and this is on the point of idle capital, of available new investment. He says that if the post-war period would bring us a new type of plane which can be safely and easily flown, and purchased at a price attainable by the great majority of people, then perhaps we may see something equivalent to that which the automotive industry did for us during the 1920's, and the period before that. But there again he throws in a doubt; he does not believe it.

I think that viewpoint involves a defeatist complex, which is akin to an analogy I have used before, that famous item of the man who resigned from the patent office in the '80's or '90's because he thought that the days of new inventions were past. Certainly none of us believes that the days of new inventions are past; certainly all of us believe that we still have technological frontiers; certainly there is no reason for casting away our system of free enterprise if we can finally get our jigsaw puzzle all pieced together, when we clearly see the true interrelation of all these many conflicting and divergent forces that have brought about these periods of depression.

I am a rather poor economist, but I don't understand the danger that lies in savings, because, after all, what are savings? We are not talking about the type of savings which the Belgian, or the French or the Chinese peasant indulged in, of burying his silver or odd pieces of gold in the ground and not working them. It seems to me that our savings in this country have always been put to work, perhaps at negligible rates of interest, perhaps at as low as one half of one per cent in net yield; but every penny that is saved that goes into the banks, that goes into savings accounts of any kind, certainly goes into employment, creation of new capital goods, employment in actual industry. That money is not idle, it is being used; and I think that the reason for idle capital during the New Deal years is not that there were not new possibilities of venture, but still that fundamental and emotional factor of confidence—the fact that the majority of businessmen in this country distrusted the New Deal philosophy, that the New Deal organization was filled with too many "pinks" and too many gentlemen with new ideologies, that the profit motive had been removed, that they were invited into a poker game where the Government took fifty per cent of the winnings, and the fellow who held the hand stood all of his own losses.

I agree fully with Dr. Hayes that high tax rates shall have to be maintained after this war, just as I believe, on the other hand, that, in periods of depression, instead of increasing tax rates, tax rates should be reduced to a very minimum, even though they run into apparent current Federal deficit, in order to stimulate investment and use of money in such periods. *Per contra*, as we get into an inflationary period, a period of too rapid expansion, the tax rate should be raised as a restraining influence upon that too rapid growth which immediately throws a monkey wrench into the intricate complications of all of our economic relations, resulting, for example, in a temporary over- production of goods which buying power cannot absorb.

I am enough of a collectivist to believe that in our post-war period we probably shall retain very high rates of estate taxation; that we are probably going to make it increasingly difficult for the so-called idle rich, but even that will have to be tempered by some sort of control which will not cause sudden and abrupt throwing on the market of securities held in estates. Collection of estate taxes should be spread over a period of five or ten years with adequate protection, but we should continue high estate taxation. But we have got to reduce our taxes on individual income, at least to the point where there is the temptation and the urge to use and to take advantage of the profit motive. Otherwise, we might as well pack up and go fishing, and raise our little garden patch of vegetables, instead of struggling and striving. While we can all approve and endorse an ideology of service to our fellowmen, we are willing to do that only within reasonable limits. The thing that really gives us the driving urge and the real advance in our material wealth, I think, is the full development of the profit motive and free enterprise.

Dr. Hayes: I would like to comment, if I may, on what Mr. Stempf has just said. I agree with Mr. Stempf in regard to some of the things that he has to say about private enterprise. No one can look about and not appreciate that private enterprise has served us splendidly in the past. But I call your attention to Mr. Stempf's emphasis upon the matter of the profit motive, to his suggestion that without the profit motive folks would not carry on, that folks would otherwise become loafers on the job. I wonder, now, if you folks agree with that. I would suggest that, if my hunch is right, there are possibly not more than two, or three, or four within the sound of my voice who have anything to do with the profit motive. I mean that you are not actuated by the profit motive. You folks are paid, as I am, a salary. I cannot conceive of any human society in which you will not have differences in reward in order to stimulate effort, but the so-called profit motive does not necessarily apply.

I was interested in what Mr. Stempf had to say about the matter of savings. His first point was that savings were never hoarded, and if he is right on that, there is no point to what I said on that subject; but again, if he is right on that, then it seems to me that we would never have unemployment. And, furthermore, I call your attention to the fact that he didn't talk more than half a minute beyond that until he mentioned the idle money during the early days of the New Deal and explained why it was idle, which is just my point as to where all the difficulty lies.

Certainly, as I tried to say in my paper, we need to make progress, we need to make progress slowly, we need to disturb our present institutions just as little as we possibly can. But I insist that what we must do is to get rid of depressions. Mr. Stempf suggested that we could do that if economists would only find out what causes them . . . . As I suggested, economists have been working on that for 150 years, and we just came through one of the worst depressions we have ever seen. I feel, gentlemen, that as surely as the sun will rise tomorrow, if nothing is done to correct our economy, we will have a depression during the 1950's or the 1960's that will make that of the 1930's look like one back in the 1830's.

MR. STEMPF: Mr. Chairman, I am entitled to a moment of rebuttal.

CHAIRMAN STARR: We would like to hear from Mr. Kohler first, if you please.

MR. KOHLER: Mr. Chairman, I have just one statement to make regarding what Mr. Stempf had to say about my remarks. Mr. Stempf misunderstood what I was referring to. I was trying to describe what is involved in a procedural audit—an audit designed very largely to replace the conventional interim audit.

CHAIRMAN STARR: We will give you one minute, Mr. Stempf.

MR. STEMPF: Dr. Hayes has rightly taken advantage of me, but he failed to mention the fact that when he spoke of savings he was speaking of his Utopian plan, that we should prevent savings. When I mentioned idle money I was referring to a temporary period of depression. Under normal conditions as our economy revolves—

DR. HAYES: Depressions are normal; that is exactly my point.

MR. STEMPF: Savings are not idle; they go into new investments. The thing that has built this country has not been our existing industry but the continuing crop of new industries, new developments, and particularly in respect to that new industry it is essential that we have confidence in the existing order of things, confidence in the rightful use of the profit motive to tempt capital into hazardous new ventures.

CHAIRMAN STARR: I would like to continue this discussion on into the afternoon but I am informed that luncheon will be served at the Faculty Club promptly at one o'clock. We will, therefore, adjourn this session.

SECOND SESSION

Friday, May 15, 1942 — 1:00 p. m.
Faculty Club (Luncheon Session)

THIRD SESSION

Friday, May 15, 1942 — 2:30 p. m.
Commerce Auditorium

Chairman

George Daverio, *C.P.A., L.L.B., Firestone Tire and Rubber Company, Akron, Ohio*

Paper: "Information-Gathering for Price Control"

Herbert F. Taggart, *C.P.A., Director of Division of Accounting, Analysis and Review, Office of Price Administration, Washington, D. C.; President, The American Accounting Association*

Paper: "Profit Limitation"

Mason Smith, *Partner, McKinsey, Kearney and Company, Chicago*

INTRODUCTORY REMARKS

By GEORGE DAVERIO, *C.P.A.*
Firestone Tire and Rubber Co., Akron, Ohio

The topics to be discussed this afternoon are of unusual importance. When I heard the President of the United States give his fireside chat some weeks ago, I was particularly impressed by the order in which he mentioned the seven principles which he said constituted our national economic policy. You may recall that the first two items which he mentioned as being of utmost importance in establishing a national program for the war effort on the home front were: *First*, "We must, through heavier taxes, keep personal and corporate profits at a low, reasonable rate." What does that mean? Profit limitation. *Second*, "We must fix ceilings on prices and rents." What does that mean? Price control. These are the two topics on our program this afternoon.

While these items appear as numbers one and two in the President's program, he said, 'the important thing to remember is that each one of these points is dependent upon the other, if the whole program is to work.' That in itself, I think, is proof of the importance of the items which are to be discussed here this afternoon.

The first subject to be presented is, "Information-Gathering for Price Control." The speaker is a man who has firsthand information on this topic. Under normal circumstances, he is Professor of Accounting at the University of Michigan. He has left his pursuits there from time to time to engage in government service. From 1933 to 1935 he served with the NRA. In 1938, he was a consultant on Distribution Costs in the Department of Accounting. He is now President of the American Accounting Association; Director of the Washington Chapter of the National Association of Cost Accountants; and is a member of the Michigan Association of Certified Public Accountants. He is at the present time Director of Accounting for the Office of Price Administration.

It gives me great pleasure this afternoon to present to you Dr. Herbert F. Taggart, who will discuss for you "Information-Gathering for Price Control." Dr. Taggart.

INFORMATION-GATHERING FOR PRICE CONTROL

By Herbert F. Taggart
Director of Accounting, Office of Price Administration, Washington, D. C.

I am here today in a dual capacity. When Russell Willcox sent me the invitation to come, he said it was because I was President of the American Accounting Association.

I am here also as a representative of the Office of Price Administration.

First, I should like to say a word or two about the American Accounting Association, and to present to you my greetings in that capacity. I have only one desire in regard to my administration of the high office to which the American Accounting Association elected me, and that is that the Association continue its unbroken record of unworldliness and impracticality, which I think represents its principal function. I had the pleasure, a few weeks back, of listening to one of the two or three top academic accountants in the country make slighting remarks concerning what he called a certain group of academic accountants with whose views he did not entirely hold. Such aspersions do not worry me in the least. The pioneer has ever been impractical and visionary. What would really worry me would be the cessation of such attacks. The Association may well be accused of not performing its function if ever it becomes wholly practical.

It has long been my desire to be present at an Ohio State University Institute on Accounting. Prior to today it has never been possible. I have looked at the programs of these meetings and I have marveled at the energy, and the excellent taste of the people who are responsible for them. Until this year, they have made not a single mistake in the people they have chosen to participate. It is with exceptional pleasure, therefore, that I bring the official greetings of the American Accounting Association to this splended Conference.

Now for the activities of the Office of Price Administration. As I was going to work the other morning, down Pennsylvania Avenue, I saw a gentleman giving a lady a bath—in fact, two gentlemen were engaged in that operation. I hasten to say that the lady was a large, heavy, cold, stone lady, sitting on a pedestal out in front of the Archives Building. On the foot of the pedestal a motto was carved in the stone, a motto at which I have looked a great many times. The words are these: "What is past is prologue."

As near as I have been able to decide, the meaning of that motto is, "You ain't seen nothin' yet." Possibly that applies to the activities of the Office of Price Administration, and to the topic announced for my address, Information-Gathering for Price Control.

I should do less than my duty by the Office of Price Administration if I did not introduce my talk by some mention of the General Maximum Price Regulation. Probably all of you have read about it in the paper; some of you may have been more intimately concerned with it than that. I am sure all of you will be more intimately concerned with it as time goes on. It is without question the largest single piece of economic administrative legislation ever attempted. It covers all prices of all goods and services, with a few specific exceptions, and also excepting those commodities which have been previously covered by specific price regulations. That is a good deal of ground—literally, all commodities from safety pins to battleships. As the General Maximum Price Regulation stands at the present time, it actually does include the price of battleships. Nobody can sell a battleship for anything above his March prices. We are in the process of devising a supplement to the General Maximum Price Regulation, which will exempt battleships and tanks and airplanes and a considerable number of ordnance items, and which will modify our control of Government purchases of quartermaster materials and the like.

However, broadly speaking, the General Maximum Price Regulation does now, and will continue to, cover the price of goods and services purchased by the Government of the United States as well as by civilians.

The Regulation covers a wide variety of services—in fact, practically all services except personal services, such as hair cuts and beauty-parlor treatments, and professional services, including, I am sure you will be relieved to know, the services of public accountants. We are not fixing accountants fees. However, we do control, or will control, the price of laundry services, dry-cleaning services, repair services on shoes, on automobiles, and on houses, industrial services of all sorts, such as textile finishing and machineshop services.

I want to call your attention to a few of the things that the accountant ought to know about the General Maximum Price Regulation, things which your clients or your employers probably will be asking you, and for which we hope you will have some of the answers.

The first item is the basis for determining maximum price. In general, with respect to those commodities in which the seller dealt during March, 1942, the maximum price is his highest price during that month. His highest price ordinarily would be the price at which he actually made deliveries during March, or at which he rendered services. However, if he were offering to deal in commodities or to render services during March, but actually made no deliveries or rendered no service of a particular kind, then his highest price during March is the price at which he offered to do these things—his listed price, his catalog price, or his posted price.

If the commodity being priced is not the same commodity or service as in March, he may still be able to price on the March basis, if the commodity or service is "similar" to a commodity or service which he was offering in March. Our definition of "similar" is one which we hope will solve a considerable number of problems of pricing which would not be solved by the rule with regard to the March prices for the same commodity or service.

Finally, if the seller sold neither the same commodity nor a similar commodity, he is permitted to use the maximum price of his nearest competitor. We have already had a number of amusing experiences with this provision. For example, a certain chain drug store operator who, since March, had opened an outlet in a new neighborhood, came to the local office of the Office of Price Administration and asked what his maximum prices would be. He was told that they would be the maximum prices of his nearest competitor. He replied, "That certainly is no help to me. I can't find out what the maximum prices of my nearest competitor are—my competitors won't speak to me, let alone tell me what their prices are." In that case, at least, the Office of Price Administration is going to have to offer a more practical method of pricing.

If commodities or services cannot be priced under any of those provisions—if they are brand new, for instance—then there must be another basis for pricing. In such case, the General Maximum Price Regulation permits the seller at retail or wholesale to use a markup procedure, which is based on the markup of the fastest selling item in the same general class of merchandise or service.

Normally, the fastest selling item frequently carries a relatively low markup, and that was well understood by those who drafted this regulation. It was one means of keeping inflation at bay, because we recognize that if provisions for pricing new commodities were overly generous, we would have an extraordinary number of new commodities; if the seller found that the pricing on old commodities was too tight, it would not take him long to discover new ones. Quite deliberately, therefore, the pricing provisions for new commodities are less than generous, in order to close that potential loophole.

Manufacturers who have a new commodity to price are directed to apply to the Office of Price Administration for the privilege of pricing the commodity, stating what it is, and indicating why it cannot be priced by any other method. If the Office of Price Administration is sufficiently impressed, the manufacturer will receive information as to the basis on which his pricing can be done. It is evidently necessary, if price control is going to work, to maintain strict control of the pricing mechanism, and exceptionally strict control of new commodities. Since no one pricing formula would serve for every manufacturing enterprise, a considerable number of formulae will be developed to take care of the needs of various lines of industry.

So much for the pricing methods.

The General Maximum Price Regulation contains a number of record-keeping, posting and reporting provisions with which the accountant should familiarize himself. I am not going into the details of those provisions, except to point out that, obviously, it is necessary that the seller maintain such records as will enable the Office of Price Administration to determine whether or not maximum prices have been ascertained properly and are being adhered to.

At the retail level the Regulation singles out a considerable list of commodities called, "cost of living commodities," which must be marked in such a manner that the customers can always see what the maximum prices are. One item of some interest to the accountant is the provision that if the store has issued sales slips to its customers, it will be necessary to continue that procedure. Furthermore, if the storekeeper has not customarily given out sales tickets, he must be prepared to do so on demand.

In a regulation as sweeping as this, covering sellers at all levels of distribution, by uniform rules, there are bound to be inequities and hardships of one kind or another. That, too, has been recognized in the Regulation. We have distinguished three broad categories of difficulties of this sort.

One category is something that, for want of a better name during the course of the discussion of the Regulation, we called "anomalies." This is illustrated by the case of a store which was holding a sale throughout the month of March, closing out various items, and which may have made no sales except at these special prices. It would be unjust to insist that the March price remain that store's maximum price. The Regulation provides for relief in cases of that sort, or in cases where price wars were going on, or where special introductory sales were being held, or where for any other reason a particular merchant selling at retail was caught by this

General Maximum Price Regulation in an abnormal position in regard to his *own* operations, not in regard to his competitors'.

In other words, if a merchant operates a cut-rate store, the Regulation is going to leave it a cut-rate store; if he operates a high-priced store, the Regulation permits the high prices to continue; but where a merchant is caught by the Regulation in an abnormal situation as regards his own normal operations, then the Regulation provides machinery for remedying those difficulties.

Treatment of this form of difficulty is going to be decentralized just as far as possible. Regional and state branches of the Office of Price Administration will make the decisions in individual cases. It is not going to be necessary for a storekeeper who was having a special sale on fur coats in the month of March to come to Washington to have a personal interview with Mr. Henderson in order to remedy his plight; he will not need to go through complex legal procedures; his remedy is going to be just as close to his home town as we can put it.

The second major category of difficulties resulting from a regulation of this sort goes under the odd name of the "squeeze." That expression was invented in Canada, at the time Canada put in its over-all pricing regulation, and the term invented by the Canadians has taken hold south of the border. The remedy for the "squeeze" is the "roll back."

The explanation of these remarkable expressions is as follows. Typically, retail prices do not advance as fast as wholesale and manufacturers' prices. The retailer, frequently, does not advance his prices as rapidly as his replacement costs increase, especially if he has an inventory of low-priced merchandise. For many years accountants and trade associations have been preaching to retailers that that is bad business; that prices should be increased as soon as replacement cost goes up. However, that good advice continues to be ignored, and as a result many retailers were caught in March with prices established several months back. In extreme cases current replacement cost is actually higher than the March retail selling price, and in many cases, replacement cost does not allow a normal markup. That is the "squeeze." The Canadians brought retailers, wholesalers and manufacturers together for a species of collective bargaining. The basic assumption of this process is that the established retail price will remain unchanged. The proceeds of a sale at retail must pay the retailer, the wholesaler, and the manufacturer. This procedure is reported to have been reasonably successful, and we hope that a similar procedure will remedy a good many such cases in this country. The

General Maximum Price Regulation provides for the collection of information necessary to take care of the roll back.

A third category of hardships consists of all other kinds of hardships which may be created by the General Maximum Price Regulation. This Regulation, like all others, provides a procedure by which any seller can petition for an amendment to the Regulation to cure any inequity with which he is confronted. There is no assurance that he will be relieved, since his ills may be incurable, but he has the right to petition for relief and to have his plea given a sympathetic hearing.

Against the background of this sweeping control of the entire price structure of the nation, we may consider the information-gathering activities of the Office of Price Administration. Under this order the importance of information-gathering becomes pretty clear. Let me cite just a few of the questions that confront the Office of Price Administration in connection with the administration of this and the other regulations.

First: What are the goods and services? At first glance, this may seem a surprising question. However, this regulation covers all goods and services except those specifically excluded, and we have begun to hear about a great many goods and services which we never heard of before. In the same manner, the NRA brought to light an astonishing number of obscure trades and industries. One method of determining what the goods and services are is to issue requests for catalogs and descriptive literature. The files of some of the Commodity Branches in Washington are jammed with catalogs which furnish a background of information concerning kinds, styles and varieties of goods. This collection is doubtless not duplicated in any purchasing department in the country, because no purchasing department could possibly be interested in as many different kinds of things as we are.

Another question is: What are the existing prices? That question includes terms, conditions of sale, discounts, allowances, etc. For its answer the OPA has acquired endless quantities of price lists, discount sheets, and price histories, including both those customarily issued by sellers and those made up at the special request of the Office.

The third question: What are the distribution channels? How are these goods sold? How do they reach the ultimate consumer? Such information is obviously necessary if we are to have any conception of the propriety and probable effect of a price action.

Fourth: What are the customary margins of the manufacturer, the wholesaler, and the retailer? This must be answered in connection with the "roll back," or in connection with any effort to set prices in proper relationship at various levels of distribution. In part, this question may be answered by the price lists and discount sheets previously mentioned.

Fifth: What are the costs and the profits? To the accountant, of course, that is the most important question. We are required by the Emergency Price Control Act to take a look at increases and decreases in costs and profits during and subsequent to the year ended October 1, 1941. We have made extensive studies already and we expect to make still more extensive studies of costs and profits to carry out that requirement of the law. We would do it, of course, even if the law did not require it, because our actions could not possibly be intelligent without that information.

Sixth: Where are "roll backs" going to be necessary? Adequate answers to the preceding questions will take care of this one.

Seventh: How can the "roll backs" be carried out? Where is the slack, if any? If the retail price of an article is $1.00, that dollar must be enough to pay all of the people involved. Now who is getting more than his necessary share? Who, therefore, can give up a little to the others?

Eighth: What are the supplies of goods? We have accumulated information with regard to inventories, productive capacities, and facilities, for the purpose of knowing what are the supplies of goods, in whose hands those supplies are located, and what are the expectations of additional supplies. This information is necessary, of course, for rationing as well as for price-control.

The final question: How is the program working? Information of that sort, of course, is an essential basis for continuing action.

You may be interested in knowing something about the machinery for information-gathering, both within the Office of Price Administration and outside of it. So far as the OPA staff is concerned, two divisions are chiefly responsible for gathering information. One is the Research Division. Its function is to make broad, fundamental, economic studies necessary for supplying Mr. Henderson with material to present to congressional committees, and others legitimately interested in our activities, and necessary for the formulation of the long-term policy of the Office of Price Administration. The Research Division make studies of national income and its distribution, of wage policies, of taxation and public finance, and of all other features of the economic picture.

The Research Division works chiefly with information from secondary sources, such as that gathered by the Bureau of Labor Statistics, the Bureau of the Census, and other public and private agencies. The Accounting

Division, on the other hand, is the chief gatherer of information from primary sources. This Division actually covers more ground than its name would seem to imply. It is composed of three branches. The largest is the Accounting Operations Branch, which conducts cost studies of products and services. In this branch there are at present something like 125 accountants.

A substantially smaller branch is the Financial Reporting branch, whose function it is to explore all sources of financial information, both within and outside of the Government. Financial data are obtained from the Treasury Department, the Federal Trade Commission, and private financial services, such as Moody's and Standard Statistics. The Financial Reporting Branch supplies the Research Division and the Commodity Branches with information concerning individual companies and broad segments of trade and industry.

It is in the Financial Reporting Branch that the work of operating the new general financial reporting plan of the Office of Price Administration will be carried on. I will speak somewhat more in detail about that plan in a moment.

The third branch of the Accounting Division is, in some ways, the most interesting. It has, in some respects—as you will agree, I think, after I have described it—one of the most important jobs in the Office of Price Administration. This is the Questionnaire Branch. That is not a good name, but it is as good a name as we could think of. The functions of the Questionnaire Branch, as I have listed them here, are six. In the first place the Questionnaire Branch gives technical assistance to all of the other divisions and branches of the Office of Price Administration in the drafting of questionnaires and report forms. There are, in the Questionnaire Branch, trained statisticians and economists who have had long experience in drafting questionnaires in such a way that, with good luck, they will bring back the information that we want, in the most economical form.

The second function of the Questionnaire Branch consists of seeking other government sources of information. If a Commodity Branch proposes a questionnaire intended, for example, to ascertain the sources of supply of raw materials, it is one of the duties of the Questionnaire Branch to find out whether the Bureau of Mines, the War Production Board, the Tariff Commission or some other governmental agency already has the required information. Not only does this procedure save government and industry considerable amounts of time and money, but it frequently gets the information much more rapidly than could be done by sending out an additional questionnaire.

The third function of the Questionnaire Branch is to inquire into the mutual interests of other government agencies in the information which may be needed by the Office of Price Administration. If, for example, we need to make a study of the supply of copper scrap, in view of the bearing of supply on price, it is evident that, for other reasons, the War Production Board and the Bureau of Mines will have an interest in the same problem. In such a case, the Questionnaire Branch would determine the interests of the other agencies and arrange to serve them either by the proposed questionnaire or by some modification thereof.

The fourth function of the Questionnaire Branch is in many ways its most important one. It has the power to approve or disapprove, for the entire Office of Price Administration, the issuance of questionnaires and report forms. The exercising of the power to disapprove saves industry from an even greater burden of government paper work than now exists. It has long ceased to be particularly funny to say that people in business are much too busy getting out government reports to pay any attention to getting out the goods. The burden has become enormously heavy, and it is not becoming any lighter. The Questionnaire Branch is aware of that problem, and I venture to say that more questionnaires have been suppressed than have been permitted to go out. The existence of the veto power is also a strong weapon for compelling simplicity and economy in the questionnaires which are approved.

The fifth function of the Questionnaire Branch is the clearance of questionnaires with the Division of Statistical Standards of the Bureau of the Budget. The ultimate veto on questionnaires throughout the government belongs with the Bureau of the Budget, and for a very good reason. For example, someone recently proposed the use of a little report form. In appearance it was not formidable; it asked only a few questions; most of them could be answered by properly placed check-marks. The first concern of the Questionnaire Branch, however, was not with form and content, but with personnel and equipment for handling the returns. They wanted to know how much the project was going to cost. The proponents had given no thought to those matters. They knew that they wanted the information but they had not concerned themselves about the cost. Rough estimates indicated that that one small questionnaire would cost about four million dollars. It is thus entirely fitting that the Bureau of the Budget should have the final say on questionnaires. Each questionnaire involves the expenditure of funds, and for enonomy's sake the several information-gathering agencies of the government must be coordinated.

Finally, for certain types of questionnaires, the Questionnaire Branch carries on the functions of tabulating and reporting on the results.

Our machinery for information-gathering also involves the extensive use of resources of other government agencies—to name only a few of them, the Bureau of Labor Statistics, the Tariff Commission, the Federal Trade Commission, the Bureau of Agricultural Economics, the Bituminous Coal Commission, the Bureau of Mines, the Treasury Procurement Division, the Department of Commerce, especially the Bureau of the Census, and many others.

A word or two about the general financial reporting plan will conclude my remarks. Doubtless many of you already have received Forms A and B, either as members of the American Institute of Accountants, or as the representatives of business enterprises. The forms are the result of a period of incubation, extending over a year or more, and are our idea of what we have to have in order to carry out the congressional requirement to take a look at costs and profits. These forms are going out to something like 20,000 American corporations in the fields of manufacturing, mining, construction and distribution, and we hope that the results will be of very considerable value.

Always after I finish talking about the Office of Price Administration, I find that I have left many questions unanswered. Some of them I can anticipate. I shall do so very briefly:

The first one is: Isn't the information-gathering activity of the OPA rather burdensome on industry? The answer is, of course, in the affirmative. The only rejoinder is that, obviously, if the OPA is to carry out its function, it must have reliable information. You would not want us to fix prices without knowing anything about the commodities, about the state of the industries, about the probable effects of our actions. There is only one way of making those determinations, and that is to get the information, and the only good source of information is industry and trade.

The second question which is always asked is this: Isn't the General Maximum Price Regulation going to be rather hard on some sellers, no matter what your machinery for relief is? The answer to that, of course, is yes. It is hardly possible that so sweeping a regulation could avoid causing hardships. The only consolation is the hope that the good of the many will recompense the sacrifices of the few.

The third question is: Will price control prevent inflation? The answer to that is: No, not by itself. The other six parts of the President's anti-inflation program are equally necessary. The other six parts, some of which were mentioned by the Chairman, are: credit control, put into effect by regulations of the Federal Reserve Board; wage control; taxation; the control of farm prices; the mopping up of excess purchasing power by the purchase of war bonds; and rationing.

The final question is: Will price control work?

To answer that would require me to be a prophet, which I do not pretend to be. I know one thing, however, and that is that whereas hundreds of reasons can be adduced to show that price control will not work, there is only one reason why it will work, and that is because it *must* work.

CHAIRMAN DAVERIO: Thank you, Dr. Taggart.

I would like to comment upon the remark that Dr. Taggart made regarding the burdensomeness of reports. I happen to know a little bit about that; and I want to assure him that he is not being misled when he is told that it is a tremendous burden upon industry. I am very happy to know, however, that he has some type of machinery set up to limit, at least to some extent, the questionnaires that are coming out to us. I think more effort probably could be spent on that particular division of work, and I think Dr. Taggart and his associates would do a real service to business if they would be even a little more strict than they are at the present time.

Those of us in industry have one primary objective in mind—to win the war. We are going to do it by production. Many of us are working extra hours every day. In our particular company we are engaged in setting up several new accounting organizations to handle the new manufacturing plants which we expect to put into production within the next six or seven months, and that is taking about all the energy we can spare. I can assure Dr. Taggart that we in industry will greatly appreciate any relief he can give us from reports and questionnaires which in some cases seem to us to be needless.

The next topic, gentlemen, is another one of the keystone programs of the present administration, and that is "Profit Limitation." You heard a little discussion—very informal—about that this morning.

Profit limitation involves something that is very serious. The President and the Secretary of the Treasury realize that the wheels of production will not run too smoothly unless they are lubricated by some incentive, as Mr. Stempf so ably explained this morning. The President recognized this in his recent Fireside Chat, when he said, "Profits must be taxed to the utmost limit consistent with continued production." Those few words are significant, because he realizes as well as anybody else that the profit motive must be retained, even though restricted and limited. Business men are patriotic, there is no question about that, but those men in industry who are responsible for constructing new war plants, with stockholders' money, must answer to the stockholders for each expansion program. Secretary Morganthau also recognized the need of the profit motive, in his testimony before the Ways and Means Committee a short time ago, when he presented his 1942 tax program, including excess profits tax of 75 per cent, and a normal tax of 55 per cent. It so happens that particular program would tax some of the income of some corporations to the extent of 88¾ per cent, leaving to the corporation only $11\frac{1}{4}$ per cent. The Secretary suggested that Congress, in the new tax law, provide for a post-war refund of, say, 8 per cent, so that the maximum tax on this particular additional income will not exceed 80 per cent.

Well, I don't think the Ways and Means Committee has voted upon that particular proposal yet, but when it does, we are hopeful that, in the interest of the war effort, it will recognize the problem and give it some consideration in drafting the first 1942 tax bill.

The gentleman who is to speak upon "Profit Limitation" this afternoon is well qualified to discuss the matter, both from an academic and from a practical business standpoint. He is a graduate of Northwestern University, and a Certified Public Accountant in the State of Illinois. From 1925 to 1929 he taught at Northwestern University and at the Ohio State University. Following this, he went to the National Association of Cost Accountants as Assistant Secretary. From 1932 to 1935 he was associated with James O. McKinsey and Company. He then went to Kroger Grocery and Baking Company, for three years, as Assistant General Manager of Operations. Then, for three years following, he was Director of Personnel for Marshall Field and Company. From 1940 to the present time he has been associated, as a partner, with McKinsey, Kearney and Company, engaged in management consultation work in Chicago.

It gives me great pleasure to present to you this afternoon, Mr. Mason Smith, who will discuss for you the subject of "Profit Limitation." Mr. Smith.

PROFIT LIMITATION

By Mason Smith
Partner, McKinsey, Kearney and Company, Chicago

Need for Consideration

The daily press is replete with references to priorities, ceilings, restraints, and rules under which American business is attempting to operate to achieve a maximum and risky production effort. One section of this general subject falls in the realm of our discussion this afternoon. Like many of the matters referred to above, this subject raises problems, the solutions for which seem relatively easy in the layman's eyes, but which we as business men know are much more difficult. The subject of "profit limitation," therefore, deserves the consideration of this meeting for reasons of the following type:

1. There has already been, through the operation of the tax laws, a considerable amount of profit limitation in force under existing legislation. Tax legislation is now up for consideration and revision, and this subject is but a part of such consideration.

2. The amount of profit earned out of the war effort is of interest to the Government, because it represents a sizable source of income through taxation to help finance the war program.

3. Any discussion of profit limitation is of immediate interest to the individual business man, because he has depended upon profit in building his own financial policies.

From the point of view, therefore, of immediate concern this subject deserves our consideration.

In addition to its interest for us as a short-run matter, we are concerned, also, because of its long-range effects. For example, we are interested first in the effect of small profits on the future of private enterprise. We are interested, secondly, from the point of view of the maintenance and development of the manufacturing plant and facilities of the nation, and finally, we are interested from the point of view of its effect on the capital structure of American business, which will be required to wrestle with the problems which follow the war.

Factors to be Considered

There are many approaches which we could make to a problem of this kind, and most of them might form the basis of an interesting discussion.

However, we cannot take the time here this afternoon to consider this subject from all the points of view under which it could be considered. For example, we could spend a pleasant time in arithmetical exercises pointing out the application of a series of assumed bases of profit limitation in companies having varying capital structures and handling contracts of varying degrees of risk and length of life. If such an approach would not please you, we could spend some time in discussing the political aspects of a program of profit limitation. This being an election year and the subject before us being one of great political significance to the masses of voters, we might turn this meeting into a good old-fashioned debate upon the political aspects alone. Thirdly, we might examine a number of proposals that have been made, some of which have been reported upon in various types of services which come to each of you from day to day. I propose to do none of these. I propose to answer few if any questions. If, in the course of these humble remarks, we can clarify and challenge our thinking on this subject along somewhat broad lines, perhaps the afternoon will have been well spent.

I believe there are a few basic factors which we ought to consider carefully before we plunge into a discussion of this subject. You will notice the topic is "profit limitation." The first of these factors, therefore, which seems worthy of discussion is, "What do we mean by profit." We will take that matter up later.

The second of these factors which I believe merits consideration is the traditional function of profit in a capitalistic system. In other words, all of you business men may have thought of profits in a variety of ways, which we will discuss later.

The third set of factors which I believe deserves consideration is certain basic assumptions, which, for the purpose of this discussion, I am adopting. These assumptions are:

1. That the requirements of the war economy are of a passing nature. Since the subject of profit limitation is but one part of the general subject of financing the war, much of what we may think, do or say will have little interest once the peace has been achieved.

2. That one of the basic things for which we as Americans are fighting is the preservation of a workable system of private enterprise. If we adopt any other assumption it seems to me that we haven't much to talk about.

3. That there exists in the economic cycle created by a war the need for preservation of as sound a relationship as possible between the amount of capital provided for a business through owners or suppliers of

venture capital and through creditors. You will notice that I said the economic cycle created by war, because we have, broadly, not only the need of financing the war but also the need for providing a financial cushion for the reconstruction period to follow. If you will accept with me, therefore, these three basic assumptions, at least we will be in the same universe of discourse, insofar as this meeting is concerned.

Profits

Profits are defined by Mr. Webster as follows: "The excess of returns over expenditure in a given transaction or series of transactions. Excess of income over expenditure, as in a business or any of its departments, during a given period of time. The word profit includes any benefit or advantage accruing from the management, use, or sale of property, or from the carrying on of any process of production, or from the conduct of business."

We as accountants and business men know that there is considerably more to this definition than meets the eye. We know that when we talk of profits we are talking of an amount which is a combined computation of fact and estimate. We know that the only time any business enterprise can be truly said to have made a profit is at the time of its dissolution. All profits for interim periods are of necessity estimated to some degree. We know, further, that when we speak of profit we are speaking of a relationship. That relationship may be to invested capital or to sales. Our experiences in the utility business over the past thirty years have shown some of the difficulties of thinking clearly about profits in relation to invested capital. We are somewhat more clear in our thinking when dealing with profits as relating to selling prices. Most of the present discussion of profit limitation at its present stage of development, however, deals with the relation of profit to total cost value of specific contracts. It would be academic to take your time to go through the various factors which make such a consideration untrustworthy from the point of view of such matters as relative risk, relative length of time, the amount of capital supplied to finance the contract by owners, etc., etc., etc. For the purpose of our discussion, therefore, we are thinking of profits in the somewhat traditional sense as performing the following functions:

1. The provision of a sufficient incentive to attract venture capital into business.

2. To provide funds for retention and reinvestment in maintaining and/or expanding a business.

3. To provide a cash return to owners in the form of dividends.

One further function may appear to some of you in the provision of funds for the retirement of debt, but I am including that under point 2. A war program, of course, upsets many traditions, and surely some of the traditional functions of profits are upset. It seems to me, however, that more emphasis could well be placed on some of these functions, even in a war economy, than are now being placed upon them in the discussions which are coming out for popular consumption.

War Program

Let us consider the war program, and its financial requirements, in terms of current needs and long term consequences, and see if the role of profits can be properly placed therein. The basic requirement of the war program is production. We have all seen instances of greatly expanded production by companies who are not financially able to handle the transaction. We have seen plants which, two years ago, employed two or three hundred men, and are now employing between two and three thousand. We have seen inventories jump many fold. This of course all goes back, in most instances, to the basic requirement of the war program—namely, production.

The financial requirements of this production program are broadly of two types:

1. Expanded plant and physical facilities.
2. Expanded working capital.

Since the war program is, we hope, temporary and transitory in nature, and since many of the facilities provided range all the way from those having no utility after the war to those of high transferability to peace pursuits, this financing is often done at great risk. Traditionally, financing of projects requiring great risk has been done by going concerns out of earnings, or by new concerns through the sale of securities of an equity nature. It seems to be the belief of the present administration, not only now but for the past eight years, that risks are reduced by being spread and underwritten by the Government. Hence, our war program is set up, fundamentally, on a basis of expecting little or no provision of venture capital by owners, either through the sale of new securities or reinvestment of earnings, and relatively large provision through loans directly or indirectly provided by government agencies. The inevitable result, therefore, of such a program is to reduce the relative stake in private enterprise which is held by venture capital, and to increase the relative stake held by creditor capital.

If we cling to one of our basic assumptions that we want to come through this war with a workable system of private enterprise preserved, it is obvious that such a program will have great difficulty in providing the required capital structure of ample safety to achieve this result. It is typical of depressions, and we may assume there will be some kind of depression after the war, that businesses tend to fall into the hands of creditors as they exhaust their ownership capital and fail to meet the requirements of creditor contracts. This risk is present in our present situation and a mere spreading of it through government agencies does not eliminate it, but merely obscures it in the people's eyes. We may expect, therefore, if we continue on our present basis that we will find ourselves after the war with such a thin margin of capital provided by owners that the process of "creditors taking-over" will be greatly accelerated. Since the creditor, ultimately, is the Government, we need not emphasize the end result of such a program.

This may be a rather black picture and you may be throwing up your mental hands at this point and attempting to erase it from the slate. I submit that if we do this we cannot come through this ordeal with sufficient stability and permanence in our American system to preserve the system of private enterprise for which we have been fighting, at least in part. But you may ask, what has all this to do with profit limitation? I would like to devote the rest of our time to that exploration.

It is evident that there is and has been a need for a greater amount and a greater margin of owner capital in American business. Owner capital will come only if it is available and, according to Mr. Henderson, it now is in considerable abundance and only if there is some expectancy of safety of principal, and some earning power. You may find that the present state of security markets is ample evidence that new venture securities could not be sold. Perhaps they could not under the present rules of the game, which have increased the difficulty of such sale during the past several years, but even if no new venture securities were sold, a substantial amount of the financing required for the war effort could be provided through reinvested earnings. The present plan, however, through high taxation, draws off these earnings and depletes the capital of business, requiring either the introduction of new venture capital or new creditor capital. If some way could be found, therefore, by which it would be possible to reinvest earnings in the war effort, it is obvious that, while the tax income of the Government would go down, so, also, would its needs for lendable funds which it is securing from taxation.

I do not pose as a tax authority or a tax expert. In fact, I know very little about present tax laws, for the simple reason that I consider taxation a matter that you had better know all about or nothing about. A little learning in this field is a dangerous thing, if you are working as a professional man for clients who have tax problems. I offer the following program, therefore, in the hope that it has some merit from the practical point of view of providing funds for financing the war effort, on a basis which would tend to cushion the aftermath of a peace reorganization to follow. I base the proposed program on the following:

1. A very large proportion of the country's plants is now devoted to war production. Thousands of firms are or shortly will be deriving all of their profits substantially from such war effort.

2. The earnings of these companies at the present time are devoted mainly to:

a. Paying high taxes which are, in turn, loaned back to industry by the Government as creditor capital.
b. Retained in the business to help internally finance the war effort.
c. Retained to provide some reserves to help the business survive after the war.
d. To pay modest dividends.

3. The present tax laws do not make sufficient discrimination between earnings realized from the war effort and from so-called normal pursuits, primarily from the point of view of the use which the business makes of these earnings. Neither the average-earnings basis nor the capital-invested basis, upon which excess profits are computed, sufficiently discriminate between these two types of profits.

4. If the tax law now coming up for consideration and passage could, in some way, recognize the essential difference in the source and use of earnings between the war effort and the non-war effort, there could be a provision for the retention of earnings with adequate tax relief for those companies engaged in the war effort, thus reducing the necessity for inordinate amounts of creditor capital.

5. Such a program, of course, would require the adoption of the necessary set of rules, regulations, and principles to guide the taxing authorities in providing a judicial discrimination between earnings derived from the war effort and those derived from so-called normal business. You may say that such a set of rules and regulations would be difficult of interpretation and application. I suggest that if this stumps you, consider the confusion which is now arising over the recent price-ceiling order of the Office of Price Administration.

6. This provision in the law could be handled in such a way that it would tend to drive funds from non-war to war industries. One of these provisions might be a penalty which would tend to place a limit on profits above those needed to finance the war effort, provided that war contracts

contained adequate safeguards in their allowed-cost sections to reimburse business for the extra strain that is being placed on plants to turn out war materials.

7. This program assumes, of course, that adequate controls would be imposed to keep any company from making and keeping exhorbitant profits from the war effort. It would, therefore, be necessary to include the following types of controls:

a. In the case of materials made for the war, for which there is of necessity little or no competitive bidding or for which there are a limited number of producers, specific limitations of profits would be required. These limitations should take into account such matters as relative risk, length of time and form of contract, the amount of funds supplied by owners and by creditors, etc. It seems to me that unless such factors are taken into account, it would be quite possible for a company with a relatively low capitalization to earn quite exhorbitant profits for the owners, yet earn but a limited rate of profit on the total contract. Another company, taking that same contract but having a large ownership equity, would earn rather modest profits for the owners.

b. The profits earned from the war effort or from normal business and retained by business to prosecute the war effort would of course represent additional net worth at the close of the war. It might be considered unsound to allow such businesses to retain all of that surplus after the war. I submit, however, that it is not any more unsound to do that than to allow the earners of high wages to build up personal capital funds to pay off mortgages on homes and in other ways substantially to improve their financial condition solely as the result of war-time bidding for their services. In either event, the stockholders, in one case, or the wage earner, in the second case, are being subsidized by the returns made from war production.

c. It would probably be necessary to include, therefore, in such a proposal some program of control over these war-produced surpluses. Broadly speaking, such a program should include a provision to allow the corporation to utilize that part of the surpluses necessary to re-establish its business on a peacetime footing. I am referring to such matters as the cost of changing product designs, due to obsolescence created by wartime inventiveness or the lapse of time, the rehabilitation of dealer and distributor organizations, where these are required, and the shifts of personnel from wartime to peacetime pursuits. This provision, also, might allow the use of such surplus above that required for rehabilitation for the purpose of the development of new products or services. It is obvious that the war has created and will create new materials, and new uses for old materials; that it has stimulated the invention of items, some of which have broad peacetime applications. In my opinion, one of the major contributions which American business can make to the peacetime recovery will be the aggressive development and promotion of such new ventures. Financing of such development should be left, I believe, to as large a degree as possible, in the hands of private business. It may be argued, however, that surpluses left after the rehabilitation job is done should be subject to tax to provide the funds for the Government for its many requirements of general rehabilitation.

Advantages of Proposed Program

War is a risky business. No program calling for the financing of it can eliminate risks entirely. I believe, however, that the proposed program has the following advantages:

1. It tends to reduce the gross amount of the Government debt, because it provides financial requirements through venture capital instead of governmentally loaned or underwritten creditor capital. There is no question in my mind concerning the desirability of the reduction of Government debt.

2. It would require, obviously, a more general participation in financing the war effort. The present and proposed method of taxation is, in effect, a very definite type of profit limitation. In fact, it acts to drain off working capital in such large amounts that many small businesses cannot live without unsound borrowing. Such a program would require some lowering of reductions on individual incomes and might require a sales tax, both of which would be socially beneficial, and would tend to increase public consciousness of the hardships of the war effort.

3. Such an enlarged participation in the war financing would act as a more effective brake on inflation than any plan of pure profit limitation. Large excess spendable funds in the hands of the masses, coupled with the shrinkage of available consumer goods, presents a most serious inflationary threat. Such a threat cannot be materially lessened without some plan of enlisting it in the war effort.

4. The plan would tend to apply the inventive and managerial brains of American business more assiduously to war production. Conditions of the past several years, largely because of the difficulty of building small businesses in the American way of reinvestment of earnings and the sale of venture securities, have definitely stunted the inherent inventiveness and developmental powers of hundreds of small business men. I could give you many examples, but I am sure that your own experience will provide you with an ample number. In short, I believe that if these small business men could feel that the fruits of their efforts in producing for the war at great risk could, at least in large part, be retained by them to pay off loans during the war, and to help them build useful peacetime businesses and provide a broad base for employment after the war, they would be much more ready to enter upon the wartime expansion which many of them are capable of managing.

I talked to one small businessman, not later than Tuesday night this week. He is so far behind that he doesn't know which end he is on. He said, "How do I go about it to supply the necessary working capital? I can get the plant, but I have to put out all my chips to get the working capital to finance this war production, and when I make the money, who gets it? I don't. I don't get enough to do a decent job on my loan."

Incidentally that brings up another point. If you get around in business and see different companies, you hear time after time, "Well, why not spend the money? It's a 20-cent dollar, it's a 30-cent dollar, it's a 40-cent dollar." Sloppy thinking, bad thinking. You cannot run businesses thinking about expenses in that way. Why are we thinking about them in that way? It is very obvious.

5. The plan would tend to create corporate surpluses which would be available, in part, for two general purposes:

a. For financing the job of business revival and rehabilitation after the war.

b. For financing the job of business expansion or for a source of taxes to give the Government required funds for general rehabilitation.

Conclusion

We have examined the role of profits as we have traditionally known them and have stated their place in private enterprise. We have reviewed briefly the present program of war financing which is based on the fundamental assumption that the Government must take away in taxes and then lend back to business. We have indicated how this plan will lead, inevitably, to an unsound post-war financial condition, because of the diluted equity of owners and the expanded equity of creditors. We have indicated a way, in the proposed tax law, to limit profits from non-war industries and non-war parts of industries, and to put a premium on retained earnings for war work, thus tending to drive funds towards that end. We believe that a provision of this type deserves more fundamental consideration than the matter of profit limitation taken alone. We think that such a provision, properly applied, can provide the funds for some significant part of the war effort, on a basis which will not put us in the position of winning the war only to lose the peace of private enterprise.

CHAIRMAN DAVERIO: I would like to express our appreciation to the two speakers of this afternoon for their excellent contributions to the Institute program.

Let us proceed, now, with the question and discussion period. Either of the speakers is open to any questions, suggestions or comments you may wish to make.

DISCUSSION

MR. HARRY E. HOWELL (Controller, The Grinnell Co., Providence, R. I.): In reference to Mr. Mason Smith's talk, I haven't any questions, because I think he said he would not answer any, but I do feel that these gentlemen here probably have not made up their minds on a matter as new and as important as this. I would like to take the position of the devil's advocate and point out that some of the assumptions upon which Mason has based his presentation have already been settled on a distinctly opposite basis. I think the American people, before and after we entered the war, and on a number of occasions have expressed, along with many other peoples in the world, the thought that if we ever came into some cataclysm of this kind again that we did not want private enterprise, any small groups, or large groups for that matter, to profit—to use popular language, "No war millionaires." I think it was realized that war brings disaster and loss to everybody. The fact that private capital is not being invited into the expansion of facilities for production of war goods is not so much the result of the tax plan as it is the result, I believe, of the expressed will of the people being carried out by Congress.

Now the question that interests me so much is: Why is it that stability in a post-war period is attributed purely to financial strength? As accountants we know that probably the reserve so loudly called for would not be funded and would not be financial strength, but book reserves, but even assuming we had the financial strength, I question whether it is wise for business to say: You leave it to us, let us have some profits and we will guarantee this transition from the war to the post-war period and we will see that there is no unemployment. I believe it is unwise, because nobody can measure the extent of that job.

I think that what will make private enterprise survive this post-war period is an environment which is satisfactory to it—one in which the people will believe that private enterprise is the right thing to have—and that environment will be much more healthy, much more satisfactory, if business is able to show that it pursued the war effort loyally and patriotically and did not make war millions out of it.

We have seen the extent to which business was criticized because it was held responsible for failure to find employment during the depression. I believe it is a terrific undertaking to assume such a responsibility in exchange for retention of profits now. I do not know what the answer is, but it seems to me that there will be such terrific dislocations of markets, products and world competition that we may need new concepts of business and government financing; that one step would be for businessmen to permit the Federal government to do what they do themselves—that is, forget to balance their budgets once in a while—in other words, to abandon the continual drive to balance the budget annually. I believe one method of doing it might well be to let the debt at the end of the war stay frozen for a period of years and immediately slash all taxes to a very nominal amount, and let that tax program stay fixed for a reasonably long period of years. That will encourage the return of capital to business, and it might encourage it into new lines, new channels, and new inventions.

I feel that we cannot succeed, in most of the decisions that we are making today, if we ignore two fundamental premises. It is very easy to argue about these matters and bring about an even balance of argument if we ignore two fundamental principles of which we must never lose sight. The first is that everything we are doing today has solely one purpose—that is to win the war quickly and completely. The second is that the manner in which the war is to be won was decided by the people before we entered the war: first of all, that there would be a practically universal conscription of man power; and second, that those who were left, corporations or individuals, were not going to get any extra profits out of this war over and above what they made under ordinary peacetime occupations.

I think that if we keep those principles in mind, we might get a little different point of view, possibly, than the one which has been expressed.

MR. SMITH: It is obviously a sound avowed purpose that no one is to profit out of this war, but we seem to be a little late in applying that purpose to a couple of elements in cost. I have been hiring some men recently for a client. I hired one for $9,000 a year, who is worth about $325 a month in peacetime. I had to hire a works manager, and a man who had never made more than $12,000 in his life asked for $30,000.

If we are going to set the rules that no one is to make excessive war profits, let's not leave the lid off on wages, salaries, and farm prices, and then adopt tax laws and take steps which I believe are fundamentally going to leave many businesses pretty close to bankruptcy because of the very high creditor equity which will exist after the war.

I have some figures here, for instance, revealing trends that have just started to show a little in the published figures. Here are three companies picked at random, at the end of 1937 and the end of 1941:

Company A—percentage of creditor equity at the end of 1937, 9 per cent; at the end of 1941, 20 per cent. Current ratio had gone from 8 to 1, to 3.5 to 1.

Company C—percentage of creditor equity in 1937, 7 per cent; in 1941, 18 per cent. The current ratio had gone from 8 to 1, to 3.8 to 1.

Company D—the percentage of creditor equity at the end of 1937, 37 per cent; at the end of 1941, 58 per cent (the company will be in a lot further than that, up to 75 per cent, before very long). The current ratio for 1937, 1.9 to 1; for 1941, 2.5 to 1.

It seems to me that a loan is a contract; when you do not pay it, somebody walks in and takes over. It may not be a direct government loan, but back of the scenes we all know what happened in 1932-33. Who bailed out the banks? The Government. Who will bail them out again? The Government.

As I see it, you have something really very definite to preserve here, if you can, and it can be done without profiteering at all. Put it this way: Here is a company I happen to know about; it is engaged in the production of essentials for the war, which the Government buys for our own armed forces and for lend-lease. The Government wants it to expand its operations. The company paid the Government $6,000,000 in taxes at the end of 1941; it is going to have to go out and borrow some money anyway, to finance working capital requirements, but it is going to have to borrow $6,000,000 more than it might have had to borrow if it had not paid the tax. Those funds are going to be used for the prosecution of the war, to finance the company's inventory, not the plant. I submit that it is much more healthy for that company to finance its increased production with $6,000,000 of retained earnings than to be forced to borrow $6,000,000. But to follow the illustration through, suppose the war went on for three years, and it retained $6,000,000 a year for three years, it would have $18,000,000 in surplus. Let's assume that the war stops in November. If it does, they are in bad shape because their inventories are seasonally high at that time. When lend-lease and military requirements are removed, prices will probably drop. If they do, that $18,000,000 wouldn't last long in absorbing the inventory loss. But let's assume that it takes only $12,000,000 of the $18,000,000 to reestablish that business and absorb that loss; they would have $6,000,000 left. They can either have $6,000,000 syphoned off in taxes for the general good at that time, or they can take that $6,000,000 to promote the sale of some new food product which is definitely for the public good. Suppose, for example, that they found out how to make a dehydrated soup which could save consumers money and cut transportation costs. I would let them have part of that $6,000,000 to develop that product and put it over. You would say: No, the war subsidized that development. I would reply that it subsidized the payment of mortgages on the homes of workers who make the soup. I don't see any difference.

CHAIRMAN DAVERIO: Are there any more questions or contributions?

MR. GEORGE R. WHITE (Owens-Illinois Glass Co., Toledo): I would like to ask Dr. Taggart this question: If consumers are going to have considerably more income, as they probably will, and fewer places to spend it, then, as I believe many English economists feel, we are going to have to have rationing.

DR. TAGGART: That is an easy question to answer. Of course we are. There isn't any doubt about it. We are already rationing certain commodities where scarcities already have attained a high level, and there is very, very little doubt but that rationing in some form or other will be extended over a considerable area of necessary consumer goods.

I doubt if we shall ever ration certain commodities which are common parts of our every-day existence—we will simply let the supplies run out and then forget about them—but the commodities that are essential are going to have to be rationed as soon as the condition arises that calls for rationing. That is one of the President's seven points, as a matter of fact. Without that, the development of the Black Markets would be even more inevitable—if there are degrees of inevitability—than is true even with rationing.

MR. A. J. BUCKENMEYER (Surface Combustion Co., Toledo): Mr. Taggart, what is the price basis for custom-built industrial machines, each machine being in the same class, but different as to size, shape, use and design? I might add, if the procedure is to set sound practice by a markup on estimated cost, will the same markup ratios result in compliance?

DR. TAGGART: The custom-built machinery industry, as well as other custom-built industries, presents very difficult problems of price control. That is recognized in the case of machinery by a special regulation which is intended to solve the problems of prices in that area.

The second part of your question, I think I failed to get.

MR. BUCKENMEYER: I said that if the procedure is to set the ceiling price by marking up estimated cost—that is the usual procedure on that type of equipment—would using the same markup ratios result in compliance? Is that the method that would be used, and if that is true, how about the labor element in the costs?

DR. TAGGART: The general provisions of the machinery regulation take the manufacturer back to his October 1 to 15 level as to material costs, labor costs and profit margins. The formula is intended to apply the October 1 to 15 profit level to the direct costs as of that date. That sounds like carrying the machinery industry back pretty far. However, a considerable portion of the machinery industry has been covered by orders and freeze letters of the Office of Price Administration since that date, so that the regulation simply carries forward a method of pricing which has been established over a number of months. To the extent, of course, that the October 1 to 15 basis is an impossible one, some method of relief will be available.

CHAIRMAN DAVERIO: If I may, I would like to offer a few comments on this question of profit limitation. We haven't heard much about the subject I am about to mention, because the problem was created by a comparatively recent piece of Federal legislation. Whether you are a private accountant or a public accountant, it is going to be of tremendous importance to you within the near future. This particular legislation was in the form of a rider attached to and made a part of a $19 billion appropriation bill, signed by the President on April 28, and concerned the subject of re-negotiation of war contracts. It will not affect small business much, because it has to do with contracts in excess of $100,000, between private contractors and the United States government—either the Department of War, the Department of the Navy or the Maritime Commission.

For the benefit of those of you who have not encountered it, I will present merely a thumb-nail sketch of the provisions of this particular rider. I think you will readily appreciate the problems involved.

One: It is limited in its application to contracts of $100,000 or over, upon which final payment had not been made by April 28, 1942, the date the bill was signed.

Two: Those contracts subject to the law, which were executed prior to April 28 must be re-negotiated by the Secretary of War, or the Secretary of the Navy or the Maritime Commission and the contractor, if in the opinion of the Secretary—Secretary of War, for example—an excessive profit was made by the contractor.

Three: Those government contracts executed subsequent to April 28 must contain a re-negotiation clause which provides for the determination of profit on that particular contract as soon as reasonably possible.

Four: The definition of the word "re-negotiation" is most important. It is defined as including the fixing of a new contract price by the Secretary, providing he does not arrive at some kind of agreement with the contractor with respect to a reduced price. In other words, if you have a contract for a million dollars and the Government examiners decide that you make too much profit, they can come into your place of business and say, "How about reducing the contract price to $900,000." If you say, "I don't think it is right," they can still say, "In our opinion it is right," and that will be it. You will, of course, have the right to a court review of their determinations.

Five: The amount by which the contract price is deemed by the Secretary to be excessive may be withheld from the final payments on the contract. If he deems $100,000 was the excess in the instance I mentioned, he can withhold the last $100,000 payment on the contract. You will then have to sue the government for that $100,000 if you feel the retention is unjustifiable and prove your case before the courts. If the final payments have been made on the contract, then the Secretary is charged with the responsibility of collecting the excess from the contractor.

Six: The Secretary may require the contractor to furnish such financial statements as he deems necessary for the determination of the amount of profit earned on each contract. This, to a large number of industrial concerns, may present a tremendous problem, because their accounting and cost systems do not accumulate costs and expenses by contracts.

Seven: The War Department may use the services of the Treasury Department, with the consent of the Secretary of the Treasury, which means that, more than likely, the Bureau of Internal Revenue will have the task of profit determination.

Eight: The Act is effective for three years after the war is terminated.

So, gentlemen, there you have a statute which has no definition whatever of excessive profits, it has no standard which the Secretary of War can use in determining excessive profits. It leaves the contractor likewise in a state of hopeless suspense.

We in industry have a tough problem, because, if this bill is continued in effect, we may not know our true position as to profits on government contracts until three years after the war is over.

You public accountants, charged with the responsibility of issuing certified statements, likewise, have a tough problem.

FOURTH SESSION

FRIDAY, MAY 15, 1942 — 7:00 P. M.
Faculty Club (Dinner Session)

Chairman:

DEAN WALTER C. WEIDLER, *College of Commerce and Administration, The Ohio State University*

Address: "Government and Business"

DR. C. O. RUGGLES, *Graduate School of Business Administrtion, Harvard University, Cambridge, Massachusetts*

INTRODUCTORY REMARKS

By Walter C. Weidler, *Dean*
The College of Commerce and Administration
The Ohio State University

This is indeed a very happy occasion for the College of Commerce. As I stand here and look over this room I see the faces of many men who have been here to a long succession of Institutes on Accounting. It is very gratifying indeed to see you back again. Then, as I look over the room, I also see many new faces, and I profess I hope that your stay here will have been profitable and pleasant and that you, too, will come back again and again.

There is another reason, too, why the College is particularly happy this evening, and that is because the two gentlemen on my right are my immediate predecessors in the deanship in this College—Dr. Hagerty, the first dean, and his successor, Professor Ruggles. The homecoming of Professor Ruggles, and the presence of Dr. Hagerty, and of all these good friends makes us very happy indeed.

I well realize the many burdens that lie on you men these days. I know of the tremendous pressures under which you are having to work, with an enlarged job on the one hand and limited personnel on the other, and I suppose you are involved in the very difficult task of trying to induct newcomers into your staffs and to make accountants out of them in too short a period of time.

All of which suggests a story which I heard recently, of a man working in a war plant, who was required to work to very close dimensions. He was very much impressed with the fineness of the work which he was doing; he met a friend on the street and he said, "I am working in such-and-such a war plant, and do you know, we have to work to very close tolerances. Just today I was working on a job in which I was required to keep within a tolerance of two-ten-thousandths of an inch." And then he said to this fellow, "Do you realize how small a ten-thousandth of an inch is?"

And the fellow said, "I know it is very small."

"Well," he said, "about how large do you think a ten-thousandth of an inch is?"

And he said, "I don't know exactly how large, but how many ten-thousandths of an inch are there in an inch?"

And the other fellow said, "Oh I don't know exactly, but there must be millions of them."

Well, I suppose you are having your troubles. This man will have to take that fellow off the street and try to make a mechanic of him, and I suppose you people will have to wrestle with newcomers on your staffs, to whom the multiplication table is a weird and wonderful thing. You are all having a lot of trouble; you are all very busy, and it is especially gratifying that you will come back and see us and spend some time with us in the midst of your very busy lives.

And now I have the pleasure of presenting some of the gentlemen at this table.

(The following were introduced:)

MR. WILLIAM F. MARSH, Past President, The National Association of Cost Accountants.

DR. HARVEY H. DAVIS, Vice-President, The Ohio State University.

DR. STUART C. MCLEOD, Secretary, The National Association of Cost Accountants.

MR. JACOB B. TAYLOR, Chairman, Department of Accounting, The Ohio State University; Director, Department of Liquor Control, The State of Ohio.

DR. JAMES E. HAGERTY, Founder and first Dean of the College of Commerce, The Ohio State University

MR. VICTOR H. STEMPF, Member of the Council of The American Institute of Accountants.

MR. CARL E. STEEB, Business Manager, The Ohio State University.

MR. HARRY E. HOWELL, President, The National Association of Cost Accountants.

MR. C. HOWARD KNAPP, Past President, The National Association of Cost Accountants.

DR. HERBERT F. TAGGART, President, The American Accounting Association; Director of Accounting, Office of Price Administration.

MR. ABNER J. STARR, The Ohio Society of Certified Public Accountants.

DR. HOWARD L. BEVIS, President, The Ohio State University.

Back in 1913, when I was a youngster, a beginner on the faculty of this University, there came to the Ohio State University campus a young professor by the name of Clyde O. Ruggles. He immediately won his way into the hearts of everyone in this community. He was with us for a considerable period of years, then found his way to the deanship of the School of Commerce at the University of Iowa; then the call of Ohio proved too strong and he returned to the Ohio State campus, was first Chairman of the Department of Business Organization, and subsequently succeeded Doctor Hagerty in the deanship, thus becoming the second dean of the College of Commerce and Administration.

In 1913 he had rare enthusiasm, great vigor, and a great capacity for friendship; in 1942 he has those same enthusiasms, just as much vigor as far as I can see, and he still has that great capacity for friendship.

He left us a few years ago to become a professor in the Graduate School of Business Administration at Harvard University. From time to time he has come back and given us the pleasure of his presence here. Many of us have seen him from time to time, quite frequently, at various meetings. He is always the same; he is always our friend, and we hold him in the deepest affection. I want to present Dr. Clyde Ruggles, of Harvard University, formerly very much of The Ohio State University.

GOVERNMENT AND BUSINESS

By Dr. C. O. Ruggles
Professor of Public Utility Management and Regulation
Harvard Graduate School of Business Administration
Soldiers Field, Boston, Massachusetts

I was asked to discuss with you Government and Business. When your Committee gave me the subject, I commented to one of them that I could remember when it was Business and Government. There has been a marked change since the turn of the century with regard to government control of business, as we all have seen.

I am very much interested in the field of accounting, and always have been, because my interest is in a field that calls for a maximum use of accounting. My interest has been for a great many years in the public service industries, and I do not need to tell a group of accountants that that is an area in which regulation will be of very little significance if we do not have excellent accounting systems.

Tonight I want to review with you something of the development of what I would call Government and Business. I would like to point out how hard it was for Americans to come to government regulation of business. For a great many years, down until within fairly recent times, the people of this country were very much afraid of any extension of the public control of industry and business. The period of marked antipathy to government regulation of business extends from about the time we broke with the mother country until the panic of 1873 and the depression years that followed. An outstanding Supreme Court decision separates these two periods, and I will discuss it a little later.

Another and more recent period—again, if you please, one identified with a depression—brought a marked surge forward in regulation. We have had in this last period a striking development of government regulation. Since the depression of the 1930's we have had men in the government who have had blueprints for both short-run and long-range planning, and they have been ready and anxious to go to almost any length in regimenting American business.

Also, we have had in this same period a great many American businessmen who were, apparently, born a little too soon to be able to adjust themselves to new conditions, and they have stood out against much of this new regulation that is fair and reasonable.

Both of those groups remind me of the traveling man who was going down through Oklahoma, and when the train stopped at the station so long that he couldn't imagine what it was all about, he got out of the train and walked down the platform to the end of the train. There he found that the natives of the city had all come in to meet the train and the trainmen were visiting with them, and it seemed to be a very jovial neighborhood party. He looked across the railroad track and saw a dog sitting over in the field with his nose pointed heavenward, howling and howling, and he turned to one of the natives and said, "What's the matter with that dog?"

The man looked at him in disgust and said, "Don't you know?"

And he said, "No, I don't know."

"Well," the native said, "he's sitting on a cactus."

So the traveling man said, "Well, for the love of Mike, why doesn't he get off?"

And the native said, "He wants to howl."

Unfortunately, there are many persons connected with regulatory agencies and likewise in business who do not approach this very important problem of the relation of government and business in any other humor than that they want to howl. Neither of these groups will make a very important contribution toward intelligent and effective regulation of business. Given time for a better understanding of the issues involved, the American public is quite likely to ignore the extreme position of the businessmen who feel that there is no good in regulation and that of the regulatory bureaucrats who feel that everything should be regulated to the fourth decimal point.

Now let us go back and trace through that early period to learn how hard it was for Americans to come to the point of accepting any regulation of business.

I do not need to tell you that the colonists who came to America came, not only seeking religious freedom, but also because those colonists knew Europe and they knew about the economic and political regimentation of Europe. They knew about the degree to which the crowned heads of Europe determined when men could enter a certain business or a profession; they knew there was no hesitation in exercising those royal privileges in dictating the terms under which men could enter an industry—whether it was the high-silk-hat business, or whether it had something to do with the necessities of life, made very little difference—it was all governed by autocratic rule.

Regulation of business reached a climax in the 17th Century in France, when Colbert took it upon himself to have his personal representatives visit the factories of France and inspect very carefully what was done in French industry. They were determined to make France a self-contained nation; it was a part, if you please, of the old mercantilist idea. Colbert not only dictated what could be done in French industry; he even dictated the quality of things that could be manufactured. For example, textiles could not be made that were not of the highest qualities—textiles that wouldn't fade when washed. Professor Gay used to point out that Colbert overlooked the fact that there was a big market for textiles in Africa and other parts of the world where the natives who would have bought them never would have intended to wash them. But there was no choice left to the consumer; the consumer determined nothing of the sort.

Now let us examine the attitude of the early American Colonists. Here we find a feeling that they wanted their freedom not only to worship, but to carry on business in their own way. It is true that we find some price regulation in the early colonial period—the regulation of the price of bread, the price of tobacco, and other things—but as soon as roads were made and markets developed, so that there was no longer the possibility of a corner on foodstuffs and other articles, all of that regulatory legislation disappeared.

I was interested in the discussion at the morning session about Thomas Jefferson. He was quoted to the effect that "that government is the best that governs the least." There isn't any doubt about the fact that Thomas Jefferson believed that, and he believed it to the degree that he was willing to fight for it. And yet, I am not so certain but that if Thomas Jefferson were alive today and gave us a new definition of *laissez faire*, it might be somewhat like the definition of liberty, given by the Dutchman to the Englishman during the Early Colonial struggles in New York. It will be recalled that a Dutchman told an Englishman that liberty was that privilege which gave the Englishman the right to straighten out his arm until it touched the Dutchman's nose, and there it should stop, and that if his arm wasn't quite straight when it touched the Dutchman's nose he had better not try to straighten it.

I have a feeling that if Thomas Jefferson were alive he would give us a new definition of *laissez faire;* it would be, I believe, that a businessman should have that kind of liberty that does not infringe or impinge upon the liberty of his fellow businessman. I can remember very well the first time I ever drove an automobile down High Street and encountered the first traffic light. Frankly, I admit to you that when I saw that traffic light I had the kind of vision we see in the funny cartoons. My vision was of portions of the Declaration of Independence. My reaction was, "Why should I be stopped?" Now, when I come to a crossing I express a few silent prayers for the presence of that traffic light; it is my salvation. But the first time I drove a car down the street I resented it, because I was in a hurry that morning anyway and I did not like it.

So it does seem that there is a new definition needed of the regulation of business. If anybody imagines that business, with its new and complicated pattern, is the business of the type that existed when Thomas Jefferson went on record the way he did, he is very much mistaken. I give Jefferson credit for having enough intelligence, if he were with us today, not to accept the interpretation that many people are now putting on his *laissez faire* doctrine.

I indicated at the outset that there is an outstanding Supreme Court decision in this country that gives us the dividing line between all that early emphasis on no regulation and the period in which we began the regulation of business. That Supreme Court decision is Munn *vs.* Illinois. It was handed down by the Supreme Court of the United States in 1877. I emphasize that because I dare say that if one will take down ten books from a library shelf that deal with that Court decision one will find the date of that decision given as 1876 in many if not most of them. Do you know why many books have that date wrong? It was a most natural error. That decision was held by the United States Supreme Court for thirteen months after the case was argued. Let me trace some events that explain why this great delay on the part of the Supreme Court.

In the first place, Munn *vs.* Illinois went through the Supreme Court of Illinois twice, and both times the Illinois Supreme Court was divided on the issues involved. They could not come to agreement, even in Illinois where those grain elevators were located. The farmers were up against it because, as an aftermath of the Civil War, currency depreciated and high prices resulted. Then with the depression following the panic of 1873, prices of agricultural products were ruinously low. They had to burn corn for fuel in Illinois, Iowa, and other middle western states because the corn did not bring enough to pay the freight to ship the corn out and pay for the fuel shipped back. We must bear in mind that such economic conditions in Illinois naturally made them feel keenly about the regulation of railroads and grain elevators. And yet their farmer legislators worked a long time before they could agree upon a law, and when that law was brought before their own Supreme Court that body could not agree that the State of Illinois had the power to regulate grain elevators as proposed in the law. The Illinois Supreme Court argued the matter and disagreed. They waited until they had another election in Illinois and new judges were elected.

Then they re-argued the issues completely, and the court divided again. Then the case went to the United States Supreme Court, and the U. S. Supreme Court divided. If you go back and read the language of the United States Supreme Court in Munn *vs.* Illinois you will see that the Court says, in essence, 'We have held this case as long as we have because we realized we were taking a very important step, and we were not at all certain that this was the step that we should take.' That is the essence of the reason why the United States Supreme Court held back the Munn *vs.* Illinois decision for thirteen months after the case was argued.

As I have indicated, that case had to do with grain elevators and railroads. Well, if there is any industry under heaven that anybody would be willing to admit, right off without any argument at all, should be regulated, it is the railroad. Of course that case hinged on the grain elevator, but they tied it in to what they called the gateway of commerce, and its relationship to the railroads was shown to be a very vital one.

Thomas Jefferson never heard a locomotive whistle. Thomas Jefferson died in the middle 1820's. Incidentally, he was a man at least fifty years ahead of his time, and yet, the very long period of time which he felt would elapse before the United States would be settled as far as the Mississippi River shows that he had no conception whatever of the economic significance of steam transportation.

If we take 1830 as a rough date for the beginning of the American railroad, let us again contrast America and France. All the railroads in France were laid down from Paris, just like the spokes in a wheel, and no French railroad was laid until very careful surveys were made by French engineers. The railroad had to be justified either on a commercial basis or a military basis, and we found in World War I that they had done a pretty good job on that score.

Now let's look at America: We had absolutely no regulation of railroad building; anybody could build a railroad if he could get enough capital to do it, and then when we built one, a second road was built parallel to it.

It reminds me of the man who bought a razor. The dealer said, "There is the best selling razor I have," and the customer took it home and tried to shave with it and couldn't. He went back and said, "I am sorry, I can't use this. Didn't you tell me this was the best razor you had?" "No," said the proprietor, "I didn't tell you any such thing. I said it was the best *selling* razor I had; I have sold so many of those razors that I have my sales talk standardized, so I know what I told you. Now to be perfectly frank and honest with you I don't believe it was ever intended that anybody should shave with that razor."

I want to say to you in all seriousness that in too many instances that second parallel railroad that was laid down in America was not laid for transportation purposes. It was used as a lead pipe against the first road, and cut-throat competition was threatened if the first railroad did not buy the second one at "a satisfactory price." Some of those roads were so closely parallel that the locomotive engineers could have exchanged a plug of tobacco (and you know in those days they used a lot of that) without ever leaving their cabs! One keen observer of that period said: "Railroads were built out into sections where nobody lived and from that point on out to where nobody cared to go." That is the way we built many of our railroads.

It is very important in tracing the government regulation of business to observe that although our railroads began operation about 1830, we did not give the Interstate Commerce Commission the power to grant or refuse a certificate of public convenience and necessity for the building of an interstate carrier until the year 1920. In other words, our American railroads were almost a century old before we ever gave the Interstate Commerce Commission that power, and curiously enough beginning with 1917 we were tearing up more railroad mileage every year than we were laying. A very fine example of waste! Not until most of the horses were stolen out of the barn did we act and put a padlock on the door. That is the way we handled the railroad building program in this country.

Then we came to the Civil War. Abraham Lincoln wanted control over the railroads; he had a tough time getting it. The Congressional debates on the bill that gave Abraham Lincoln the power to take over the railroads show that many Congressmen who voted to give Lincoln that power felt the need of apologizing for their votes, and that the power was voted only as a war measure, not as anything desirable.

After the war was over, in the year 1868, a resolution was introduced in the House of Representatives that you and I, looking back at this time, would consider superfluous if not crazy. That resolution read: "Does Congress have the power to regulate interstate freight rates and interstate passenger fares?" Curiously, when they looked around for a committee to which they could refer this resolution, they didn't have a Committee on Railroads. That looks as though they hadn't been thinking about regulating them very much. They referred it to the Committee on Canals. The Committee on Canals went over the resolution carefully, and citing the Constitution said that Congress did have the power to regulate interstate passenger fares and freight rates, "but that the Committee did not believe such regulation was necessary."

In 1866 somebody introduced a bill into the Iowa Legislature to regulate freight rates, and it was referred to the Attorney General to see whether the legislature had the power to regulate freight rates. The Attorney General went into the matter carefully and issued a long and labored report, much of his conclusion being printed in italics. He maintained that the Iowa Legislature had no power whatever to regulate railroads. The Iowa Supreme Court, in 1869, handed down a decision (which I haven't time to discuss with you) which was of the very same tenor.

Now please note that in 1874 the Legislature of Iowa passed one of the most rabid pieces of legislation that was ever printed on railroad rate regulation. If I had that law here tonight, it would stand up on that table like a book, possibly, without any binding on it. So you know it must have been a very elaborate piece of legislation. The reason it was so elaborate was because they figured out every rate between all possible stations in Iowa on every commodity from asbestos to zinc, and they had the exact rates to be charged, following a strict distance tariff principle. I mention the matter in which the legislature itself undertook this early regulation because I want to refer to the *methods* of regulation a little later.

One could draw also on the experiences of Wisconsin and other agricultural states and find similar attempts to regulate the carriers. It wasn't very long, however, before the people of the Middle West saw that these rigid state laws did them no good. They all had a commodity that had to go to the seaboard markets. What good did it do them to try to pass a law regulating intrastate commerce in Iowa, Wisconsin, and Illinois? They had to get their grain back to Baltimore and New York, and that required interstate commerce. If we trace the history of the Interstate Commerce Act, such names as Windom of Minnesota, Cullom of Illinois, Regan of Texas, and McCleary of Iowa stand out. In one day in Congress some thirteen different bills introduced for Federal regulation of the railroads received inspiration and support from Senators and Representatives from the Middlewest.

But even when the Interstate Commerce Act was on the statute books it was not a very effective statute. Let us consider briefly the 20th section of the law which, as this group well knows, was on regulation of the accounting of the railroads. That is, it was supposed to regulate the carrier accounts. But you will remember that the Interstate Commerce Commission had some sharp differences with the Lake Shore Railroad on accounting practices. That road was tearing up light rails and putting down heavy ones and including it all in maintenance. The Interstate Commerce Commission asked for facts which would show how much should be considered as maintenance and how much as extension of plant. You will remember that the Lake Shore Railroad refused to give the facts. It went to the Supreme Court of the United States and that court ruled that the 20th Section of the Law of 1887 was not mandatory, and that the Lake Shore was not compelled to furnish the information.

Hence, control over railroad accounting had to make a new start after this Supreme Court decision. This was done in the Hepburn-Dollivar law passed in 1906, becoming effective July 1, 1907. I do not have time to analyze this law, but its control over rates was of little significance, judged by present-day regulation standards. From the point of view of accounting, it did not have anything of significance on depreciation. Professor Eckleberry, of this University, went into that carefully for a Master's thesis; he pointed out that there were as many rates of depreciation on railroads as Heinz has pickles, and we aren't even yet dealing with the subject of depreciation in the way with which we must if we are to have intelligent and effective and helpful regulation of business.

We have put the cart before the horse in much of our regulation because we have made requirements which assume effective accounting control when we have not had it. In Massachusetts, in granting early railroad charters it was stipulated in these charters that when the Massachusetts railroads had made 10 per cent they had to turn the rest over to the school fund. Horace Mann was a great educator and did much for the schools of Massachusetts, but it does not appear that he received any financial assistance from Massachusetts railroads. Apparently, Boards of Directors of Massachusetts railroads never sounded the alarm when they had earned 10 per cent and turned the remainder into the School Fund. It seems strange that regulation of profits should ever be attempted with no regulation whatever of accounting.

Turning attention now to the depression years of the 1930's under Roosevelt, let us take a look at more recent developments of regulation. Here we see not only the regulation of public utilities, but we see under the NRA an attempt to regulate all sorts of business activities.

You will remember, of course, that when the Supreme Court was called upon to pass on the NRA, it was a unanimous Court that said it was unconstitutional—liberals, conservatives, all said it was unconstitutional.

Why was it unconstitutional?

Because it did not provide sufficiently definite standards by which business was to be regulated. I used to belong to a volleyball class here at Ohio State and also in Cambridge. These were fine groups of men and we had a lot of fun, but, you know, we made the rules as we played. We had no standards for the game other than those we made during the progress of the game. Of course it was bedlam making the rules and revising them as we played. We cannot do that in business. The Supreme Court ruled in the NRA case that the Congress had to be definite, and that the Congressional mandate did not provide, as it should have provided, sufficiently definite standards to be followed by those who were to enforce the law.

We seem to be getting around to this: the legislatures cannot legislate unless they do so strictly and explicitly; and yet they cannot possibly legislate strictly—and it is no reflection on the legislatures to say this, for there are at least two good reasons why they cannot. In the first place, the men who make up the legislature cannot possibly be experts in all the different areas in which it would be normal to regulate business; in the second place, even if they were, legislative remedies alone would be too rigid. The legislature is supposed to meet once in two years—down South they are so afraid of legislators they will permit them to meet only once in four years. But with a legislature attempting to regulate business directly, the result is a rigid and inflexible law for an unforeseen business situation which may change radically within a very short time and obviously the legislation no longer fits the problems involved.

We seem, therefore, to be confronted with the stubborn fact that we must have an intelligent analysis of what is to be regulated; we must have certain standards by which certain administrative agencies can be guided, and those administrative agencies are expected to introduce enough flexibility into their procedures so that they may take into consideration the new situation that arises and yet, at the same time, follow some fundamental principles in applying the rules of conduct to business.

That naturally raises the question: What of the future of regulation of business?

You would know from what I have already said that I do not expect to see less regulation of business in a postwar world. We would have had an increasing degree of regulation of business if Franklin Roosevelt had never appeared on the scene. Careful students of business history know that. They know that regulation was overdue for a good many areas.

Now, the important thing is to work out some sort of pattern that will enable us to be both intelligent and effective in doing the kind of fundamental work which is necessary before really satisfactory regulation can be achieved. Many of the problems that need to be regulated today are economic and business problems. But we will never have satisfactory regulation unless we apply to these problems economic and business solutions.

A political solution will not serve; it is not that kind of problem, and the sooner we recognize that, the sooner are we going to be in a position to set up the kind of administrative agencies that can do the job.

Let us not fool ourselves about the difficulty here. It will be difficult to get these administrative agencies up to the level of responsibility and efficiency which will be necessary if they are to do their jobs as they should be done. I am highly pleased by some recent Supreme Court decisions with regard to these administrative agencies, and I am referring especially to one that was handed down on March 16, involving the natural-gas industry. There the Supreme Court went on record to the effect that, in regulating the rates, and also the rate of return, they were not going to be meticulous in holding these administrative agencies to some particular formula of valuation. That may eventually call for a revision of the Ohio Law. I do not need to tell you the emphasis that the Ohio Law puts on reproduction valuation as a rate base. Apparently, the Supreme Court is not going to be too fussy about that.

At any rate, that is an interesting decision and of great interest to accountants, because it seems to promise somewhat more of a future to accountants than it does to valuation engineers.

If these administrative agencies deserve to have more discretion, apparently the Court is willing to give them the green light. If that is true, it is up to us to try to improve the administrative agency. I want to close with the thought that we will not get any better administrative agency than we are willing to create, and there the public has a very heavy responsibility. I maintain that these administrative agencies are as important as the courts; in some respects I believe they are more important.

I was very much interested in Mr. Justice Frankfurter's statement in the Driscoll Case, handed down in 1939. I feel that it indicates fairly clearly what is likely to be a more general belief as time passes. He said, in that case, in speaking of utility rates and rate of return, that these are not questions for which a lawyer's training and a lawyer's experience offer us any solution; that if the solution is found to rate-making and to what constitutes a fair rate of return, it must come from the men who have studied finance, economics, and related lines.

I have no doubt in my mind that that is where the solution does lie. If I am having serious eye trouble, I want to go to an eye specialist who knows how to doctor the eyes; I do not hunt up a corporation lawyer. And it seems to me that it is no reflection on the courts—indeed it seems to me a compliment to the courts—that they are willing to say: Here is a problem of business regulation that must be turned over to those who understand the problems of business and understand the issues involved. If our administrative agencies are made up of such men, it will promise much real progress in the regulation of business.

The courts stay at home and tend to their business; they do not go around hunting up these jobs of deciding these matters. If the businessmen and representatives of able administrative agencies can get around a table and discuss frankly and openly the problems they have to settle, and if they will reach a real solution, it will never need to go up to the courts.

So I close with this thought: American business has become very complex, so complex that the businessman must recognize that he must have regulation of the other fellow in order that he may enjoy his rights. It is precisely the same sort of thing that we have in traffic regulation or anything else, and because we must have this regulation in order to work together in a satisfactory way, then the businessman's own salvation is not in blind opposition to government regulation of business but in what I call an intelligent attack on the problems of the regulation of business.

In too many states the term of the Governor expires at the very same time that the terms of members of a number of these administrative agencies expire. That is vicious; it encourages a governor to campaign on a platform that will pledge to his supporters places on these administrative agencies. There ought to be a staggering of those terms, and the men on those administrative agencies ought to have longer terms than do the governors. Moreover, the members of the administrative agencies ought to be paid salaries comparable to the courts themselves because their great importance to the public demands it. Then we could begin to attract better men to these administrative agencies, and when that is done we will not have so many cockeyed rulings with regard to some important matters of business, and businessmen will begin to realize that some of the men on regulatory agencies understand business problems.

I see no other hope for the future regulation of business! I see no cessation of government regulation. There is going to be more of it. Our only hope is to make it more intelligent and to make it more effective. I have tried to show you that control by direct legislation cannot do it. The courts cannot do it. It is no reflection on them to say this. Moreover, they do not want to do it.

How *are* we going to do it?

We must do it through the flexible, intelligent, and creative type of body that we are now calling the administrative agency. Careful students of these administrative agencies will look forward in the hope that, in a number of states, the governors will be stripped of some of their powers to control these agencies. Probably the trend of the times showing increasing public faith in administrative agencies was registered in the attitude toward various bills for the reorganization of some of the Federal agencies. You will remember that Congress was unwilling to give the President of the United States control over a number of those agencies. That refusal, in my opinion, is fundamentally sound. It does not matter who is President; such a proposal is wrong. The President cannot possibly deal with these problems, and not until the public wakes up to the fact that these problems call for a kind of regulatory body that must be encouraged and built up, and for which the public will have respect, will we have a satisfactory solution to the problem of government regulation.

If we can develop such regulatory bodies, I will risk the guess that in the long run many businessmen who are now complaining most bitterly against some of this regulation will be ready to say that these administrative agencies are approaching the problem in a sane and an intelligent manner.

FIFTH SESSION

SATURDAY, MAY 16, 1942 — 10:00 A. M.
Commerce Auditorium

Chairman:

JOHN R. WOOD, JR., *C.P.A., Time, Inc., New York*

Paper: "Control and Allocation of Labor Costs Under Abnormal Conditions"

HARRY E. HOWELL, *C.P.A., Grinnell Company, Providence; President, The National Association of Cost Accountants*

Paper: "Control and Allocation of Expenses Under Abnormal Conditions"

DONALD M. RUSSELL, *C.P.A., Lybrand, Ross Bros. & Montgomery, Detroit*

INTRODUCTORY REMARKS

By John R. Wood, Jr., *C.P.A.*,
Time, Incorporated, New York, New York

It is a pleasure to open this fifth and final meeting of the Institute on Accounting. I think this has been a very interesting series of meetings. Yesterday we had four talks, all on major policies; they really developed into major economic policies as well as accounting policies, which we as accountants should be interested in. I think it is a credit to those who planned the program that their choice of subjects was such that it gave the speakers the opportunity to broaden their talks to reach into these things which are so interesting to us today, because we are still thinking and planning the future of our American way of life, the same kind of thing that we are all fighting for, and we want to see that we come out with the right result after we win the victory.

Today, instead of discussing our national economic problems, we are just going to be accountants talking shop. This is good, right-down-to-earth material, and it takes in the kind of problems that we run into every day on our own jobs, and I am sure you are going to find these talks, too, very interesting. The topics are very closely related—the "Control and Allocation of Labor Costs Under Abnormal Conditions," and the "Control and Allocation of Expenses Under Abnormal Conditions."

I wrote to Russell Willcox and asked him about that word, "abnormal," in each title. I said that I was in the University here in years which were "abnormal"—1929-1931; and in 1935, which was "abnormal," as we thought at that time; and I think that 1940 was abnormal in a way; and this is 1942, and I think it is very abnormal—I hope it is. So I think Russell has run on to something which can serve him as a title for all the rest of the Institutes that there may be. This is good for any year that he may want to run it, so what we are going to have now is the 1942 edition.

We are going to change the procedure just a bit; Mr. Howell has a plane to catch and after his address we will have the questions and then he will have to leave us.

The first speaker is Mr. Harry E. Howell. He is in constant daily touch with the topic he is going to talk to us about; he is the Controller of the Grinnell Company of Providence, Rhode Island. He had his formal education abroad; he is a Certified Public Accountant in the State of Rhode Island and a member of the Bar in the State of Massachusetts, and is the National President of the National Association of Cost Accountants. Dean Weidler told me last night that he is the only man who has been the President of a National Association of Cost Accountants chapter on three different occasions. It is a great pleasure to introduce Mr. Harry E. Howell.

THE CONTROL AND ALLOCATION OF LABOR COSTS UNDER ABNORMAL CONDITIONS

By HARRY E. HOWELL, *C.P.A.*,
Controller, Grinnell Co. Inc., Providence, R. I.

Until May 1 it might have been difficult to present a paper on the subject of proper accounting for the unusual, but not necessarily abnormal, labor costs which we now encounter, but it is no longer difficult. On May 1, *N. A. C. A. Bulletin*, Volume 23, and No. 17, contained a "tentative statement on accounting for excess labor costs" that so completely states the problem and the principles underlying its proper treatment and the preferable accounting cost practices in regard to it that little more can be done than to review and substantially quote from the excellent report which was prepared by Dr. Marple from material gathered by the National Research Director of the National Association of Cost Accountants.

In the latter part of 1940 it became evident that there were some new costs coming into business in relation to labor, and we were very much interested in them. So much so that early in the spring a questionnaire was prepared and sent around the country to find out just what was being done in an accounting way with these labor items.

The results of that survey were published on August 15, 1941, in *N. A. C. A. Bulletin*, Volume 22, Number 24, and I refer you to both of these bulletins because they are authoritative in showing what the condition was in 1941 and the way in which we are treating it now. In Dr. Marple's report I believe the sound basic principles which will enable us to handle any of these costs are set forth.

It was interesting to note last August the tremendous confusion in regard to handling this subject: 263 questionnaires were analyzed; of those we found that 122 concerns were taking all of these costs and including them in their inventory valuations; 78 of them were excluding them; and 63 of them were picking them up on some normal or arbitrary basis, part of them going into inventory and part being charged off.

It was very interesting to me to analyze those companies that had charged these costs into inventory, and to find that the likelihood that they would be so charged was three times as great where there was an actual cost system as where there was a standard cost system. This seemed to me to imply that the decision was not made so much on principle as on expediency. In other words, the type of system determined how these labor cost items were handled.

Now the problem that presents itself is probably more clearly seen in the handling of overtime pay, night premium pay, and in training costs. Again your Chairman's remarks on "abnormal" are very sound, because all of us have known that in good times and bad we have run certain units, certain departments, on a consistent overtime basis. It has been wise to do so to conserve the capital expenditure in that particular unit or to get a greater utility out of the remaining investment. In such cases, that overtime, that night premium is a regular part of the operation and should be comprehended in the regular costs.

It is common, for instance, in foundries, no matter how low you are running, to have the cleaning and the grinding done after the melt is over and usually with the night shift, and quite often you have to pay a premium of so many cents an hour or a certain percentage to have the men work. It is quite customary in processing, such as galvanizing, lacquering, where you have a very small unit, to run that unit, even in depression times, twenty-four hours around the clock in order to get the maximum utility of the capital investment. Those costs are regular and usual and should be picked up in the same way that you would pick up the regular labor cost. The costs that we are chiefly concerned with today are those which may be attributed to the additional volume we are getting, either as the result of direct war contracts or indirectly as the result of the boom increase in business arising from the war. The question in regard to their treatment, the fundamental one, it seems to me, is the problem of when they shall be absorbed. Shall we charge them off into the current period, thus putting them into the profit and loss statement, or shall we bypass them temporarily from the profit and loss statement by including them in inventory valuation and having those costs appear as an element of inventory in the balance sheet?

When you first look at it you say: Well, these are costs of the production department. It is true there are a few that are not. For instance, you are having to pay overtime in your accounting departments and you don't think twice about it; you undoubtedly charge that additional cost off to expense, along with the original labor charge. But when we come to overtime or premium time in the shop, the first thought that we have is, Well, these are production costs—and we try to spread the production cost to the product and include it in the inventory, because we feel that is where these additional charges should go.

Well, that reasoning is not necessarily correct. There are some exceptions, in good cost accounting, to the rule that all costs incurred in the production department shall be included in the inventory valuation. In the first place those concerns that are running on a basis of absorbing their fixed overhead on the normal capacity basis have made it the practice of charging off under absorption of fixed overhead. Likewise, those who are running standard cost systems have regularly charged off, and not included in inventory valuation, the losses reflected in their rate and use variance accounts for material and for labor. They have realized that those are excess costs, unusual costs, costs that might have been controlled and have not added to the value of the inventory, and they have written them off.

Another exception is the fact that at the end of the year, or during the year, you have examined your inventories, and re-priced them, revalued them. To some extent that involves a correction of steps that you have taken during the year to include in inventory costs which you now realize should not be there. This, it seems to me, gives some recognition, possibly not very clearly, to a principle that I hope to see developed in regard to inventory valuation—namely, that the increase in cost was not recognized, or would not be recognized by a potential customer; he wouldn't pay any more for it because you were inefficient or because you happened to do his job during an overtime period. It certainly seems that, in repricing your inventory on the basis of market or recoverable value, you are applying that principle, and that if we apply it in this particular case it may solve the problem of what to do with these overtime and premium charges, at least on regular business where our customers will not pay us for the added cost.

Now, these overtime charges come under a group of costs which we normally treat in our standard cost accounting as variances which should not be included in the cost of production in the valuation of inventory, and if you examine costs of that kind you will find that they possibly fall in this group: that they are costs which you did not have at the beginning of the period and possibly will not exist at the end of the period. Such costs as, for instance, temporary inefficiencies of labor—when you set your standard you did not have them, you did not comprehend them, and you hope that at the end of the given period they will not be there. And if we find costs of that kind, we usually treat them as something that is a cost of the current profit and loss period, and therefore we charge them off and do not include them in inventory.

I think you may find that upon such an analysis you can justify the charging off of overtime premiums and other excess labor costs, rather than including them in inventory valuation. I believe that we have to recognize the fact that because items can, for cost ascertainment purposes, be allocated to products, that does not necessarily mean that, because we have done it, such total of cost must be carried forward in the balance sheet as part of the inventory value.

We have seen the efforts which have been made to eliminate price profits from inventory—last-in-first-out, and all of the other methods that were designed to prevent the inventory valuation from upsetting the current profit and loss statement. A similar problem, it seems to me, is involved here. Inclusion of these costs in inventory, while inventories are steadily rising, has the effect of by-passing these excess costs out of the current profit and loss statements and to that extent you are over-stating the profit and you are paying out good cash money in taxes—on unrealized paper profits in inventory.

I realize that we have not brought the Internal Revenue Department to this point of view (although the Treasury Department has recommended inventory reserves), but I feel that if we clearly set these costs out as special expenses, unusual expenses—if enough of us do it and enough of us argue about it—we may find some relaxation of the rule that inventory shall be priced at actual cost. In any event, tax accounting is not necessarily a criterion of good accounting, and regardless of how we may later have to adjust them for the tax people, we should keep our own accounting records on sound, clear principles, so that we know what we are doing.

It seems that if we do include these costs in our inventories, thus over-stating current profits, we are building up inflated values in the inventory. Then, in a post-war period, when it will be very difficult to maintain ceiling prices which will recover these costs, we are faced with deflation of the inventory, with heavy write-downs of our assets, and with heavy losses on what sales we do make.

Even if the overhead cost per unit is reduced by the added volume that you are getting (and that has been advanced as an excuse, with the argument: We will charge these labor costs in and they will be offset by the reduction in fixed cost per unit due to the added volume), I feel that it would be better not to hope that increases in labor costs and reductions in overhead costs per unit will offset each other, but to segregate both. Then if it is true that you get a fixed overhead credit in the variance account, permit it to offset the excess labor debit variances in the profit and loss statement, but don't trust that somehow they will offset each other in the inventory account.

Now if we go on the principle that the question as to whether or not these costs shall be included in inventory shall depend upon whether or not they are realizable in the sales price, it may clear up the handling under one or two situations. Let us first take the case of a firm with government contracts: If you have a government contract that provides for reimbursement on a cost-plus basis, or on cost with a fixed fee, or if you have a government contract at a flat price, but in the setting of the flat price you estimated costs which included running at an overtime rate, or the running of night shifts, which comprehended that you would have these excess costs, I see no reason, in view of the fact that the sale is made and the selling price ascertained, for not including those costs in the costs provided in that contract. That, it seems to me, is a justification for including those costs in the inventory and carrying them in the contracts in process or work in process inventory.

Now there are some sound reasons for making the fullest possible distribution of costs on government contracts. If we take many of these excess costs and lump them in the accounts so that they are part of our general cost, we may have some difficulty justifying our showings on government contracts; they may appear to show far greater gross profits than is actually the case. I think we have got to be ready—not only for the sake of proper reimbursement, but also to show our good faith in the handling of government contracts and the fact that we have not made excess profits—to distribute the cost to the greatest possible extent. It may appear that there is some conflict in principle there, but I don't think there is, if you follow two thoughts: first of all, the thought that there is not one cost for all purposes; that it is possible to have a cost for estimating that is different from the cost for inventory valuation; and it is possible to have ascertainment of cost of the product, carrying it through maybe to the point of including costs of distribution—selling, warehousing, freight—and all sorts of items that can logically be applied to that product, and arrive at a cost which, while it is a satisfactory cost as a cost ascertainment result, still has nothing to do with the cost that you would use for inventory valuation.

Similarly, if you follow the principle that we may include in inventory these costs of which we are sure of reimbursement, then it seems to me that the handling of government contracts and the inclusion of those costs which you know are reimbursable is proper and logical.

However, the situation is considerably different where you are manufacturing for stock, where the goods are not sold, where it is impossible to ascertain the price at which you will be able to sell them. In that case you will have this problem of carrying forward, to future periods, losses, excess costs, which should be charged off in the current period. You have the problem of inflating the inventory; you have also the problem now of the fact that price ceilings may be established which will cut the margins or fix the margins so that you have no hope of recovering these excess costs in the selling price.

It seems to me that the price ceilings established by OPA give us an opportunity to use them as a basis for setting new standards of cost, and we know that when we set standards of cost we endeavor above everything else to arrange our accounts so that the variances from that standard are shown up separately. If an OPA price ceiling is established based on normal operation, and normal operation does not comprehend overtime and premium allowances, as it probably does not, then the management is entitled to see the extent to which their regular gross margin is being cut into by these unusual items. It probably may bring about efforts to control it, to minimize it and to restore the gross margin, not by raising the sales price, which cannot be done, but by controlling these costs. If the accountant charges such costs to inventory, the management does not see the effect until the sale is made, and quite often that is a long time later, and too late to do much about it.

There are one or two points in regard to the allocation of overtime that involve some problems. Where you do not charge such costs off immediately, but you are going to include them in the cost of some job or some product going through the shop, the question is whether it is advisable to collect them against a specific job, or how would you charge them? It is the old question that you had in peacetime; that the particular job was forced over into overtime wasn't the particular fault of that job, but the management decided to push it into the overtime period. If the management has the decision, it seems to me it puts it into an embarrassing position, particularly if it has both government and non-government jobs, and must charge the overtime worked specifically to some job. It seems to me the government auditors might very well take the stand: well, you could have done government work during the normal hours and done your own work during the overtime hours.

The facts again seem to determine it, and this may seem to state it very simply, but the result of the questionnaire in August showed this: not so much the fact that, once the program was understood, we couldn't apply sound principles, but the fact that many accountants had not realized the importance of this problem and they had not segregated these excess costs so that they could be looked at, studied, and treated separately. They had been blanketed into the overhead, or blanketed into the direct labor cost.

Similarly, with the allocation of overtime: if we can set up the overtime, see where it was and how we did it, it should not be too difficult to determine how to handle it. A job may be figured to be done in overtime in the first place, as is many times the situation, both on construction jobs and in your shop, in order to meet a difficult time schedule. You may figure the only possible way to do it is on a sixty-hour schedule, and naturally you figure that you have got to pay for 70 hours of labor under most wage laws today. The same situation applies on construction; they tell you that you have to work seven days a week, two shifts; you naturally figure in your costs the excess cost of running beyond the normal forty hours. If you are working on a contract that requires compliance with the Walsh-Healy Act, and you know that you have to work ten hours a day, then you know that you have to figure on eleven hours, regardless of how many hours the man works during the week.

To the extent that overtime work is comprehended in figuring the job in the first place, and presumably reimbursement will be made, and is comprehended in the selling price, it seems to me that the overtime can very well be charged to that job. But if there was no such plan, if it just happens that the production schedules broke in such a way that some jobs unfortunately lap over into the overtime period, and some luckily stay in the normal period, the fairest way to compute the cost to government, to private jobs, and any other jobs you are working on, is by pro-rating over all production, preferably as a special loading on labor, not as part of the burden rate.

There have been one or two interesting things develop in regard to the way in which these abnormal labor costs have been recorded, and you realize that if they are not recorded properly, if they are not recorded so that they clearly stand up, our treatment of them is confused. Many companies treated their additional cost as part of the direct labor pay roll. Other than the fact that the Wage and Hour Law makes it necessary to show the premium hours separately, there would have been no way of telling what the breakdown of the pay roll was as between pay for hours worked and pay for premium hours.

In the first place there is a possibility of error in such a procedure. Moreover, you have lost control of the important element, at least to the extent that it is controlled through accounts. In the second place those who distribute costs on the basis of direct labor have introduced an element into their direct labor base which causes very serious distortions, and in many cases it makes it difficult to obtain reimbursements from the government. I know that on construction jobs particularly, they don't look kindly upon the reimbursement of the total pay roll, including overtime and premium hours plus your overhead rate—that is, your construction overhead rate, plus any other charges that you may have. What happens is this: your normal pay roll may be reimbursed to you at pay roll cost, plus workmen's compensation and public liability insurance, plus social security tax, plus a per cent for superintendence, use of tools and various other construction overhead items—but if you try to collect that on the premium hours, it will be disallowed. On premium hours they will pay you only pay roll cost, plus workmen's compensation and public liability insurance, plus social security tax; so that it is wise, it seems to me, not to introduce these items, upon which the overhead allowances may be different, into the direct labor base.

Other companies have charged excess labor cost in the burden, and the only objection to that practice that I see is that, in the first place, you lose track of the item; and in the second place, you embody it with a group of costs which may be distributed on a basis which is not applicable to this particular cost. It may go into some group that is distributed on the basis of material, or production hours—all sorts of bases which, if they happen to be the right ones for distributing this particular excess labor cost, would be pure coincidence. It seems to me that we should charge excess labor costs to a separate group of accounts and clear them through separate variance accounts, so that we can analyze them, and in clearing the variance accounts we can study them and determine the proper bases for doing it.

Now it seems fairly clear that these costs are now important and large enough to warrant correct treatment, and this would imply the following: First, proper segregation of the charges, and non-inclusion of these charges in the cost of hours worked. That is not in your straight labor costs, or in your burden, but in separate cost accounts, and clear through separate variance accounts.

Second, proper distribution as a separate cost element based on the nature of the item and the ascertainment of the correct basis of distribution.

And third: After such distributions are made where they are necessary for cost determination, the application of sound inventory valuation principles to determine whether or not such costs should be carried into the inventory account, or instead charged off to current profit and loss.

If we use these rules, let us examine a few items in addition to premium overtime hours, night-shift premiums, already discussed. They seem to fall into two groups: first, payments to labor in addition to normal rates; and second, payments for services on account of labor.

In the first group we have as a first item, wage advances. That is, where the base rate itself is changed. You may wonder why there should be any thought that that will be treated in any other way than as a direct charge to the cost of the job, as part of the direct labor, but you may know that in many contracts the wage rate is set and established and you cannot obtain reimbursement unless you get all sorts of approvals. A construction contract often states, for example, that the rate of wages shall be as established in October 1941, in Cook County. It may happen that you may have a union agreement which expires on November 15, and which must be renegotiated with a wage increase. There is nothing you can do about it. The union isn't going to hold up its territorial agreement merely because you happen to have one job, so that you have the problem of attempting to get the proper contracting officers to accept the addition, which is proving to be very difficult, or immediately agreeing to the arrangements which you made with your union, and thus having an excess cost which is not reimbursable.

It seems to me that, in those cases, it might be a good idea to set that out as a separate cost and show it as a separate deduction from the gross profit margin. Certainly you are misleading the management if you include it in inventory valuation; they think that that is recoverable money. If you want to show that you think it might be recoverable, and don't want to charge it off, it would be a more complete disclosure if, instead of carrying it in inventory, or contracts in process, you carry it as a contingent claim—contingent account receivable.

On regular products you have a problem, in regard to wage advances, that seems to me to be very important.

We know that, regardless of price ceilings, selling prices are not necessarily directly related to our costs. They are related to competition; they are related to what consumers will pay. Now we have, it seems to me, two types of wage advances going on at the present time. One of those wage advances arises from the action of unions of certain skilled groups who are compelling an increase in labor rates. Those are the ones which receive a tremendous amount of publicity. On the other hand, there is a group of wage increases which in some cases is being voluntarily given by concerns. When they have been compelled to raise the wages of a small group they have seen it wise and expedient to voluntarily raise the wages of those who are less articulate.

Now there is a great mass of wage increase involving, let us say, non-union people—office people, salesmen, a whole multitude of people who are not craftsmen in some organized union—and what we have to consider very carefully is whether or not the wage that we are talking about is in the nature of a permanent raise, a re-adjustment of the share that labor is going to get out of this thing, or whether it is a wage which we can look upon as being one that has been compelled by circumstances that will correct themselves.

We heard a speaker say yesterday that they were going to have to pay $750 a month to somebody who was worth $300. I think I would look around a couple of weeks and see if we could find somebody we know is worth $750, but fundamentally, that chap who is not worth $750 is going down to $300 sometime. On the other hand, we have seen a situation where we have had, in some industries, clerical workers in the offices at $12 and $14 a week who are now getting $16, $18, and $20, and it might be wise to figure that that is going to be a permanent increase in our costs.

I cannot—nobody can—lay out any particular principles for the handling of that situation except these: that when a wage adjustment is made we should not immediately assume: Here is our new rate of wage, we will put it in our pay roll account and distribute it along with all the rest of the wages. I think that it would be very wise to temporarily set it up in a special variance account so that we can look at it, so that we can see how much of it is of the type that we must bear for a long time, how much of it is a type which is arising purely out of this emergency, where it is more or less of an increase not economically justified and obtained under duress, if you want to put it that baldly, and to what extent it is going to affect our regular peacetime production costs when the war is over. It seems to me that, where we realize that we are going to have it as an adjustment of base level of wage, we must understand that it is going to be with us for a long time. This is true, for instance, of some of the payments over 40 hours required under the Wages and Hours Law. In such cases, we probably should readjust our costs, pricing of our inventory, notify our managements that there is a cut in the gross margin, and that there isn't much that can be done about it. However, management will probably come back and say: The OPA outfit set a price ceiling and they have not given us an allowance for this.

I ask you gentlemen to consider this: You have been living under price ceilings all your life—the only difference is that the government is setting them now. Either you have had the price ceiling set for you by competition, or if you are a big enough frog in the puddle you have set it for your competition. What you have done was this—you did what was done in the depression: If you figured the cost of an article as $1, you went to your sales organization and said, "You have to sell this for $1.10." They said, "We don't have to do any such thing. John Jones is selling it for 90¢ and if he can do it we can". So they would go out and sell it for \$.89, and you would have to take out the margin of profit, set up a standard cost and go ahead and try to get in line with that cost.

That can be done. It has been done, it can be done, and should be done. I like to feel that, under the price ceilings established by OPA, you men who are running cost accounting systems will take this opportunity to reinstate in full vigor the control of costs which that system will give you. Take the price ceiling, not as something to be complained about, but as a challenge from a competitor, and break down and reduce your costs. There has never been a greater necessity for controlling waste and extravagance than now. If we can make the cost of these products lower, if we can make the expenses of the government in the prosecution of this war less, the tax burden will be less; there will be less drawn out of us.

It is very poor psychology to assume that we can have no control over costs; that we must always get out high production with so much waste.

Up to the time when the price ceilings were established on non-war products as well as war products, it was easy for management and for the cost accountant to excuse himself for not doing his full job; it seems to me today there is no excuse whatsoever. If you are working on government jobs with flat prices or cost-plus-fixed-fee, you have made certain commitments, and the estimates which you made in making those commitments should be taken into your cost system and used to control and to see that there are no wastes or expenditures beyond those which you originally estimate.

On the other type of products, which you are selling in the open markets under price ceilings, it seems to me that first of all we should endeavor to sell below the price ceiling, which merely establishes a maximum. We are not doing this country or ourselves any good if we try to use the ceilings as an excuse for raising prices. In the second place, we can take those price ceilings and say: Here is a standard already created for us and we must control and conform our costs, and find savings and curtail inefficiencies so that we can live under the price ceiling. There is nothing new about it; you have all done it before many times, and some of the greatest advances that have been made in cost reduction or in getting more production from a given cost have been made by the compulsion of a price ceiling set by your competitor, and that same compulsion exists today with a much more important objective in sight at the end.

Along with wage advances, as an element of abnormal costs, we have guaranteed day rates to learners, and that is an extremely heavy cost in many industries. While you may still have these men on piece rates, or you may have established quotas to be produced for a given flat rate, nevertheless you just cannot get people to work unless they are guaranteed a certain flat rate, and that rate quite often will run, during a training period, 50 per cent, 40 per cent, 30 per cent of the total pay roll, and the problem is: what to do with it.

A further matter of arbitrary decision of the management is that of determining that this particular job will be done by a green hand and this one by an experienced hand. It seems unfair that the charge should be made not because of the intrinsic need of the product itself, but because of the decision of the management. I think we can use the same principles which would be followed if we had originally comprehended an extensive training program to perform a government job. We would know that our costs were going to be reimbursed, or that our flat price would include such an allowance. It is proper to segregate that cost. Thus we can see what it is, and apportion it to the job on which we are going to get reimbursement.

But where there is no specific reimbursement, where we are working on government and non-government work and it is scattered through the organization, and our loss of help to war industries has been heavy and we have to train new people, it seems to me that that is a general cost of doing business. First of all it should be segregated so we know precisely what it is, and then it should be figured as a labor loading charge, which we should try to recover on new jobs and new figuring. But again I do not believe that it should be charged into the inventory.

We also have another unusual labor cost, and that is retroactive wage adjustments. Quite a number of those are going through. Ordinarily we can charge those back and treat them in the same way that we did the original pay roll, and there isn't much against that, except this one thing: Quite a number of contracts, as I said before, state the rate of pay and you cannot assume that, merely because you have been compelled to retroactively raise wages, you are going to get reimbursement. It is the first duty of the accountant, it seems to me, to set up the retroactive wage adjustment in a separate series of accounts so that we can see what it is. Second, the apportionment cannot be done in a blanket manner. Assuming that the firm is going to be reimbursed, the accountant has got to study the contracts to see if they provide reimbursement. If they do not automatically require reimbursement, it seems to me the retroactive wage adjustment should not be charged directly into inventory. If you want to show it as an asset it should appear as a contingent account receivable. Then when you get an adjustment to the contract, permitting you to charge it, you can clear it through that account and put it back in inventory; if you don't get it, the management has been put on notice that here is something which is a contingent asset, and you can charge it to profit and loss immediately.

A similar situation in regard to abnormal costs arises on the usage of labor. We are seeing a continual growth of inefficiencies. Some of those are controllable, some could have been controllable if the cost man had adjusted his system so that the production man could have used it. But the primary job was to get out production and since the cost man approached the production men with variances measured with cost accounting micrometers, the production men naturally tossed them out. The cost man who was smart enough to adjust his system so that he measured his variances with a foot rule or a yardstick, in big totals and long term trends, has received and will continue to receive very respectful attention. But to the extent that labor costs arising from inefficiencies are not controllable, it is a dangerous thing to include those costs in your inventory, particularly if you wouldn't expect the customer, on your regular production, in peacetime, under ordinary competitive conditions, to reimburse you for your inefficiency as compared with your competitor. And that situation is far worse now, because when you start to sell those products again in the postwar period you will have fierce competition, and it seems a correct point of view would be to charge those costs off.

In the second group of abnormal expenses and labor costs—and I am not trying to make an all-inclusive list, I am merely trying to point out there are so many of them that they warrant special treatment—are those I have included under the heading of labor service cost. A couple of them are regular and usual. The reason I mention them is because the treatment of them in many situations is, to my mind, not sound—for example, that treatment of workmen's compensation and public liability insurance, which in many concerns buries these items in some manufacturing overhead, and distributes them on some basis which does not do such an accurate job as distributing the items on the only sound basis; namely, the pay roll. It seems to me that we should run separate cost accounts which will enable us to distribute workmen's compensation, public liability insurance, social security taxes, as a labor burden rate directly to the pay roll cost. That, incidentally, would be on the pay roll dollar, including the premium dollar, because, as you know, you pay so many cents per hundred dollars of pay roll regardless of whether those were for hours worked or premium hours.

Now we have a number of other labor service costs that are running into real money. Among these are the cost of pay roll preparation including all the deductions, and the carrying of war savings bonds, group health and accident insurance, and compliance with the government requirements for pay roll. In some situations, you can put the pay roll department out on the job on location and recover the cost. You can then charge the costs into contracts in process, because you know you are going to be reimbursed for them. Where that is not the situation, and you have a single pay roll department for labor working on war and non-war jobs, the costs are getting so heavy that I question whether it is proper to include them in some general overhead which is deducted from gross profit, or which is used as a blanket-plan overhead rate. I think that it can be segregated and possibly distributed to departments of costs on the basis of so much per man, which might be much more accurate than on pay roll dollars.

Another cost that we have that is increasing tremendously is the cost of identification—tags, badges, finger printing, checking into personnel departments before hiring men, etc. That is running into a very heavy cost. It seems to me that management should know what it is; it should be clearly segregated. Again, the same principles of applying it to the product and carrying it into inventory, which would require, certainly, recognition of the principle that we are going to be reimbursed for it, should be clearly understood. Again it probably should be distributed on a per man basis rather than per hour or per dollar.

Well, as I have said, this Bulletin of May 1 brought this whole problem into focus, stated the problem, and stated some of the underlying principles. If it is possible to draw any conclusions at this time, I would say this: that these things are extremely important in amount; they are extremely important in their effect on costs; they are extremely important in their effect on inventory valuation; they are important now and many of them are going to be with us permanently. It is, therefore, the same job we have always had, as cost accountants, in regard to any cost of that type: First of all, to isolate it and segregate it so that we can look at it; and second, study it to see what caused it, what its effects are; and third, apply a sound principle of allocating it, if it has to be allocated, and sound principles of inventory valuation to determine whether we should charge it off in the current profit and loss period or by-pass it into the asset account and treat it as an asset.

In doing this and in working with these labor costs, I think it is important that we do not perform the act of the dog sitting on the cactus. It means a lot of work for us; we are liable to feel that all of these things are impositions placed upon us by pressure groups; we are liable to approach the work in a critical and non-cooperative attitude. Now it is true that cost men are not supposed to have any great influence in the handling of labor, but on the other hand you men who have tried to install incentive plans, piece-rate plans, or even your ordinary pay roll methods and the handling of paychecks, know that you can cause much irritation by a carelessly thought-out plan, one which upsets the men or makes them feel that they are being treated rather discourteously. With one small error of that kind you can upset the work of industrial relations departments, and all of the house organs and other morale builders that you can think of.

I do suggest that, in the handling of these accounts and their reactions on labor, we realize this: that, as is so evident now, while this war is going on, the greatest asset we have is man power. We don't want to be too short, too ill-considered in our criticisms of our man power. If we feel ourselves inclined to criticize labor, just remember your feelings in regard to some of the boys here on the campus, two or three years ago, with their curious clothes, their funny habits, their jitterbugging, and all the rest of it. I listened so many times to the viewers-with-alarm saying that our youth was decadent, that they weren't like we and their grandfathers were. They have proved in the last four months that they are just as good and probably better than their forefathers; they have done a fine job. I think it is true also of labor. We don't want to let the surface things that get the publicity fool us; underneath they are sound, they are fine, they are doing a splendid war job.

When this war is over, the thing that is going to make business able to meet the shock of a depression, if it is able to meet it at all, is not reserves, even if they are funded, and it is not the plant full of fine machinery. It is just one thing: it is man power, trained man power, skilled man power, cooperating man power that believes that the free enterprise system can work, that they want it to work, and that under it they will have reasonable security and the full freedoms to which they are entitled after they have given respect to the rights and the freedoms of their fellow citizens.

CHAIRMAN WOOD: Thank you very much, Mr. Howell. Mr. Howell has asked to be excused from the questions because of the fact that he must make a plane. I would suggest that we hold our questions and see if Mr. Russell does not come close enough to permit you to adjust questions which you may have now to something that Mr. Russell may touch on. In that way we will try to cover the points that you may have.

If that doesn't happen I am sure Mr. Russell will be glad to try to answer a direct question even though it may be on the phase of the subject covered by Mr. Howell.

MR. HOWELL: I wish to say that I am sorry to miss the discussion, and if any of you want to start an argument by mail, I will be glad to carry it on.

Chairman Wood: Mr. Russell's topic is a little broader than Mr. Howell's topic, "Control and Allocation of Expenses Under Abnormal Conditions."

Mr. Russell is a Certified Public Accountant, a member of the American Institute of Accountants, and a resident partner of Lybrand, Ross Brothers and Montgomery, of Detroit, Michigan. He was graduated from Worcester Polytechnic Institute and attended the Harvard Business School of Administration through 1916. During the first war he was in the United States Navy, doing cost inspection work. Later he joined the Philadelphia staff of Lybrand, Ross Brothers and Montgomery.

CONTROL AND ALLOCATION OF EXPENSES UNDER ABNORMAL CONDITIONS

By DONALD M. RUSSELL, *C.P.A.*,
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This topic, the control and allocation of expenses, is one which suggests many different things to many different people. Entirely different pictures come to the minds of persons who may be operating standard cost systems and to those operating actual cost systems, to those dealing with commercial work, to those dealing 100 per cent with Government contracts, and to those operating mixed commercial and Government production, to those starting new enterprises and to those having long established experience in cost standards and cost records. However, as was brought out in our meeting yesterday, we are all getting on somewhat common ground, due to the control of all of our economic life which has been assumed by the Government under these abnormal conditions.

Under the Executive Orders of the President (No. 9001, issued December 27, 1941, and No. 9127, issued April 10, 1942), Government officers have received very broad powers, both to re-negotiate contracts and to audit the books and records of all contractors and sub-contractors engaged in defense work under contracts entered into since September 8, 1939, so that our consideration of this topic is quite necessarily directed first to the Government interpretation of cost problems under war contracts.

I would like first to raise one or two questions which are of general accounting interest—the effect of the Government's definitions of cost and the Government's conception of fixed fees upon the general financial statements and their effect upon the determination of realized income available for dividends, to be reported to stockholders in the annual reports of corporations.

Financial Statements: We know that under the Government definitions we are permitted to include in cost, not only the usual manufacturing costs and expenses, but also a part of selling, administrative and general expenses. Ordinarily, selling, administrative and general expenses have nothing to do with inventory valuation; to put them into the inventories is to defer a part of these expenses to a future period. How do we stand if we value our inventories according to the Government definitions, from the viewpoint of being consistent with last year, and from the viewpoint of determining realized income?

It is very well to say that perhaps we can put these elements of cost into the inventories and then take them out again for the financial statements, but that may be a very difficult thing to do, particularly if we are required or desire to keep costs by individual parts. Some of the contracts call for parts' costs as well as total contract costs. I would suggest, in preparation for handling this question, that it would be a good idea never to lose sight of the total gross cost put into a Government contract, even though we bill out our costs every month on public vouchers. We may need to know the total gross costs, cumulatively, at every closing date, because we may wish to make an estimated adjustment to convert Government-interpreted cost back to what we usually think of as cost. If this adjustment is made it will probably have to be done by the use of an over-all or an approximated percentage.

I think it would be well, also, in handling these contract costs, to remove from the contract cost accounts items which are temporarily in dispute and put them into a suspended cost account. That will serve two purposes: it will focus our attention upon doubtful items, and also, it will help us to keep the billings current. I believe some companies already have run into difficulties in having to make repeated analyses of open balances in contract cost accounts because of the differences between what they have charged into those accounts and what they have been able to "bill up" on public vouchers with the approval of the Government auditors. Therefore, I think it would be distinctly helpful to segregate disallowed items by classes in a suspense account for the purpose of keeping the record clean and keeping the unbilled balances current.

I am speaking about inventories as the proper term to describe unbilled costs on Government contracts. From some points of view perhaps the unbilled balances are accounts receivable. Under conditions where the Government takes title to all of the material immediately upon disbursement of the funds, it may be that the costs incurred immediately become accounts receivable. However, in many cases, and particularly in smaller concerns acting as subcontractors, they must continue to handle these accounts as inventories, even though they are having to adopt Government interpretations of cost.

If a portion of selling, administrative and general expense is to go into inventory, what is the proper treatment for the offsetting credit?

One method is to charge items directly out of selling, administrative and general expenses or to short-cut those accounts. If that is done, our selling, administrative and general expenses appear to be very much smaller than in the preceding accounting period, because part of them have gone directly over to the Government costs. Another method is to show the distributed amount in the selling, administrative and general expense section of the income account, as a special credit. Another way might be to show inventories of selling, administrative and general expenses at the beginning and end of the period, or to put into the income account the increase or decrease in the inventory of selling, administrative and general expenses includible in costs under the Government definitions.

All of these methods, however, result in getting that credit into the net income account, and reporting it as true income for the period; that is, income available for dividends. I suggest that we might give consideration to the procedure of crediting the item to a deferred account in the balance sheet and later adjusting that account by transfers to the credit of cost of sales proportionate to the transfers of the inventories to cost of sales.

The reason why that idea appeals to me, at least theoretically, will be shown also by considering the nature of the fixed fees. We get into the idea of thinking of fixed fees allowed under cost-plus contracts as being the income or the profit from those contracts. As a matter of fact, the fixed fees have to include most of what we usually call selling expense, and a considerable share of what we call administrative and general expenses, and under the interpretation of T.D. 5000, the fixed fees usually have to cover interest which we ordinarily class as an "other deduction" in our income accounts, and also has to cover the federal income and excess profit taxes. Thus, the fixed fees really are closer to the gross income in our profit and loss statement than they are to net income.

Government contracts provide for many ways of billing or collecting these fixed fees. Some of them provide that we may bill them proportionately to the public vouchers. In that case we may spend 50 per cent of our total cost for materials in the first month or two of the contract, and immediately bill to the Government and collect our fixed fee. If that fixed fee is then taken into the income account directly, it appears that we are anticipating the realization of net income. We are probably taking it into our income account too early. Under these circumstances should not the fixed fees also be credited when billed to a deferred account in the balance sheet? The transfers of fixed fees plus the transfers of the credits for distributed selling, administrative and general expenses, at such times as shipments are made, would result in the recognition of realized income in a manner consistent with commercial practice. Of course, some contracts provide that the fixed fees may be collected upon shipments; that is more in step with commercial practice, and there perhaps would be no occasion in that type of procedure to use a deferred balance sheet account.

We should bear in mind, all through this talk, that, while I am basing most of it upon the Government procedures for cost-plus-fixed-fee contracts, our fixed prices are all subject to re-negotiation, and when we come to re-negotiate, the definitions of cost and the definitions of allowable profits are going to be the definitions of costs and fixed fees under the cost-plus-fixed-fee procedures.

Negotiated Flat Charges: We find frequently that negotiations have been made to avoid determining actual cost by using flat charges; for example, flat charges for purchasing and clerical expenses on construction contracts where general overhead expenses are not usually allowed. Flat charges may be applied to toolroom orders in lieu of actual material, labor, overhead and profit, or we may find management fees for operating a Government-owned plant. If the amounts are incidental and no profit is intended, they may be credited to the expense accounts for which they have been substituted. If significant in amount, however, it appears that the distributions of expense should be based upon the gross amounts of expenses incurred. The resulting difference between the flat allowance and the actual cost of the service rendered should be closed direct to profit and loss. Section 26.9 of T.D. 5000 provides that no *loss* on another contract shall be included in cost. Neither should the *profit*, if any, be credited to cost. This procedure would, moreover, furnish information as to the adequacy of the negotiated flat rates for use in subsequent negotiations.

Standard or Normal Costs: Particularly where commercial work is continued along with war work, the contractor will be fortunate if he already has in operation long-term standard costs. It would be most unfortunate if concerns which have developed, over the years, reliable cost *standards* and standard *costs* should abandon them now.

The added volume of operations results in decreased fixed costs per unit of commercial product. From the point of view of the cost standard, this should be recognized as an abnormal and temporary condition, and the standards should not be revised downward for this reason. As pointed out by Mr. Lawrence Downie at the N.A.C.A. convention in 1940, such reductions in costs, if permitted to reduce *prices* of commercial products, would result in price structures that would be ruinous to the particular industry after the termination of the emergency period. The variances should be analyzed in such manner as to segregate the component variances due to performance or changes in prices from those due to increased volume.

The volume factor is bound to result in favorable variances on commercial work which represent additional profit due to sharing the actual fixed or stand-by costs with the supplementary Government work, and this particular credit variance is a profit that belongs to the contractor. The Government also profits on its work by being charged a smaller share of the fixed costs on its contracts than it would sustain if it did not share the fixed charges with commercial work. If standard costs are applied in costing the Government work, the credit variances due to volume in excess of standard which are applicable to the Government work must be credited to the Government.

One exception may be noted, however, to the principle that savings from lowered costs on commercial activities due to increased total volume belong to the contractor. In the case of plant facility construction contracts, it is the theory of the Government that none of the fixed charges for the contractor's general expenses are to be included in the construction cost. That is another way of saying that the other operations of the contractor's business must continue to stand a normal overhead, it being assumed that the general overhead would have been incurred anyway, even if there had been no construction contract. This applies to executive salaries, corporate taxes, and most of the items we usually classify as administrative and general expenses. This exception appears to be imposed even if the other operations of the contractor have been discontinued by Government edict. The theory is that the contractor will make his profit on the supply contract to be performed after the construction has been completed.

Government auditors, usually, will agree to the temporary use of either standard costs or normal burden rates to expedite current reimbursements, and subject to later adjustment to actual costs. I believe it will be possible to arrange for such adjustments on an annual basis on a long-term contract. The correction factors, undoubtedly, will need to be applied in some detail to achieve a reasonably accurate apportionment. It is doubtful, for example, that the apportionments between commercial work, fixed-price contracts, and cost-plus-fixed-fee contracts can be made on a factory over-all basis; the variances from normal burden rates, undoubtedly, should be departmentalized and traced back to the original charges to the limits of reasonable expenditure for clerical expenses. The variances should be related to the total costs incurred rather than to the charges billed; that is, credit variances should be disposed of with due regard to inventories.

In the absence of an elaborately developed standard cost system, with a completely established procedure for the analysis of the numerous factors which cause variances, it would appear that any standards or normals in use which result in unusually large variances on the war contract work should be promptly revised. The variances must be disposed of to the satisfaction of the Government auditors; if they are so great as to appear to destroy the reasonableness of the first cost computations, a great deal of difficulty with the Government auditors undoubtedly will result. Any computation for the disposition of the variances will be less accurately distributed than the first computations, otherwise the cost accounts would be entirely rewritten. This situation must be avoided by close attention to the variances incurred from month to month.

Direct and Indirect Expenses: In the Government's prescribed treatment of expenses, there is greater stress laid upon the determination and segregation of direct expenses than has been customarily used by industry. Government auditors dislike distributed indirect expenses and much prefer a large basis for distribution and low percentages of overhead. Under this point of view, the greatest possible proportion of the total pay rolls should be disposed of by direct charges; upon occasions the auditors have even gone to the extreme of requesting that executive salaries be charged direct. This general principle is not contrary to the best accounting practice; in fact, most cost accountants will agree that distribution of expenses from their sources is to be preferred, wherever possible, to the pooling of expenses and distribution of the lump sum. The commercial rule that "direct expenses" may be treated as "indirect" if the costs of treating them as "direct" are unreasonably high, and if the difference in the end results is immaterial as compared with the clerical cost involved, should still prevail.

Under Section 26.9 of T.D. 5000 there are three tests of "direct" expenses:

1. They must be "properly chargeable" directly to the cost.
2. A detailed record must be kept by the contractor of all items of a similar character.
3. No item of a similar character which is properly a direct charge to other work may be included as a part of any indirect expenses prorated to the contract.

As the contracts uniformly refer to good accounting practice as the standard of accepted allowances of cost, we must rely upon that to interpret the first requirement that the items must be "properly chargeable" directly to the cost. There appear to be at least two approaches. The first is adequately described by the term "causal responsibility," as used by Mr. Harry Howell in his paper at the St. Louis N.A.C.A. convention in 1940. This approach is at the source of the expenditures; the other is at the receiving end and is the test as to what extent the contract received benefit. We must ask as to each item:

1. Did the contract cause the expenditure to be made?
2. Was the existence of the contract responsible for the expenditure?
3. Did the contract receive all of the benefit from the expenditure?

If the answers to these questions are in the affirmative and the tracing of the causal responsibility or benefit is complete as to the particular contract standing alone, the expenditure is a direct charge.

"Indirect" expenses are those of joint benefit to several contracts or lines of product and those expenses incurred for the business as a whole which are of some benefit to the Government. They exclude all expenses which have a direct causal responsibility or benefit to only one contract, and they exclude those expenses incurred for the business as a whole but which by Government definitions are unallowable elements of cost because they benefit only the corporate entity and do not benefit the Government. The Comptroller-General of the United States has the final word, and his opinions show a strict interpretation of what is "related to the contract." If no relation can be traced, the expenditures apparently fall within the class, "contemplated to be borne by the contractor." Every item to be included either in "direct" expenses or in distributed "indirect" expenses must have, in some degree, a relation of causal responsibility or of benefit to the contract.

In the revision of any cost system to meet the requirements of accounting for war contracts, the importance of adequate departmentalization of the plant can hardly be over-emphasized. If the Government production is in a completely separate plant, all of the expenditures at that plant have a direct relation to the contract, and there is little difficulty in proving the right to reimbursement. If the work must be carried on in a plant with commercial work, the greater the extent to which the Government work can be segregated in departments devoted 100 per cent to that purpose, the smoother the arrangements will work.

One difficulty arises before production begins in a plant where direct labor is the usual basis for overhead distribution. The same difficulty also is likely to arise towards the end of the contract period after production labor has been discontinued. Several months may elapse during which executives, engineers, purchasing agents, production-planning men and others may spend a great portion of their time on a new Government contract. Under the usual distribution of expenses, no charges could be made to the contract, because there is no productive labor on which to base the distribution. In this situation, those men, and all men of their service classification, should be requested to make daily time reports, so that the directly related services may be charged directly to the contract. Moreover, special cost studies should be made to determine burden rates to be added to the direct charges for their salaries, for these men use desk space, heat, light, elevator service and other services. Such special burden rates can well be computed by establishing the building or buildings in which the work is done as cost centers and arriving at a distribution of the total building costs based upon the pay roll for the entire building.

The requirement that if certain items customarily treated as overhead expenses are singled out for treatment as direct charges, then all items of a similar character must be so treated, causes some difficulties. It is a proper requirement. In practice, it has to be administered with reason, and frequently the resident auditors will agree that while many items have the same account classification in the books of account, they differ even within that classification, and there must be a residue that cannot be charged direct and which may be included in the distribution of the "indirect" expenses.

Segregation of Selling Expenses: Some concerns still carry, in their general accounts, two general divisions of expenses: manufacturing and commercial. The commercial expense controlling account is unsuited to present conditions whether operating fixed-price or C.P.F.F. contracts.

This account should be divided into two accounts for adequate control: (1) selling expenses, and (2) administrative and general expenses. As each of these groups, ordinarily, will contain certain unallowable expenses for Government contract accounting, it would be desirable to segregate the unallowable expenses under each classification in separate controlling accounts. All four accounts should be closed directly to the profit and loss account for general statement purposes, but the two representing expenses allowable for Government contract accounting will be available for computing the necessary cost distributions. For cost accounting and Government inventory purposes, the allowable administrative and general expenses account may be distributed, as suggested in T.D. 5000, directly to contracts, on the basis of total manufacturing and installation costs incurred for the accounting period, i.e., usually the current month. The contracts, of course, include all commercial, fixed-price and C.P.F.F. contracts or orders. Another method might well be to distribute to both manufacturing and selling operations on the basis of total pay rolls under these divisions for the month. The allowable selling expenses, also, according to T.D. 5000, may be distributed directly to contracts and orders, either on a basis of sales completed during the period, or total manufacturing and installation costs during the period. If the total pay roll method has been used for the distribution of allowable administrative and general expenses, the allowable selling expense plus its pro rata portion of the distributed administrative and general expenses would be transferred to general manufacturing for further distribution.

Sales Branches: Many concerns being converted entirely to war production have extensive selling branch organizations. Attention is invited to the wording of T.D. 5000, which lists among the items which are excluded from the cost of performing a contract or subcontract the "expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacant or abandoned, or not adaptable for future use in performing contracts or subcontracts." If branch plants are adaptable to and are being converted to war use, it appears that the expenses, maintenance and depreciation of such facilities should be included in the allowable selling expenses and distributed with other expenses of a general nature over all of the production of the concern.

Idle Plant Facilities: Aside from the problem of selling branches, we may have manufacturing facilities which are clearly to be excluded in our distribution of expenses. It appears evident, in addition to the quotation just given, that in respect to all permitted distributions of indirect expenses, all elements of expense therein must be "properly incident to and necessary for the performance of the contract," or again, from paragraph (j) in Section 26.9 of T.D. 5000, "all items which have *no relation* to the performance of the contract or subcontract shall be eliminated from the amount to be allocated." The wordings of these definitions, and the published opinions of the Comptroller-General indicate that *losses* of the contractor, as distinguished from costs and expenses of the contractor in connection with facilities needed for the contract or of present or future benefit to the Government, are not contemplated to be includible in Government costs. In other words, it does not appear that the Government intends to underwrite or subsidize the fixed charges which the contractor may have as a result of his capital investment in plant assets not suitable for war use any more than it subsidizes the small concern that may be forced by war conditions to go out of business. If it becomes necessary, as a part of the conversion of a plant to war use, to place certain machinery and equipment under tarpaulins out in the yard until after the emergency, such machinery should be segregated in the accounts and its carrying charges should be omitted from the cost computations. If, on the other hand, the machines can be converted to war use, and are expected to be so converted, they constitute *stand-by equipment,* and the carrying charges should be claimed in the overhead distribution accounts.

Depreciation and Amortization Allowances: One question that arises is whether we are bound to the same depreciation allowances permitted by the Treasury Department. Every case, of course, stands by itself. If our depreciation for tax purposes is based on corporate cost of the assets, and if our tax return rates of depreciation, applied over the years, have resulted in net asset values that are fairly representative of the remaining useful lives of the assets today, there would appear to be no reason why the same computations permitted by the Internal Revenue Code should not be acceptable for cost purposes.

It appears to be generally recognized, however, both by the Treasury Department and the business public, that many depreciation schedules, particularly those resulting from cumulative computations over a long period of years, have become quite distorted from present facts. During the 1920's many concerns were over-generous in depreciation allowances, and sometimes these rates were even carried through the depression years. For the past six years or more, the Treasury Department has been consistently reducing the allowed depreciation rates, in many instances basing the allowances upon the idea that the accumulated reserves should not be allowed to rise above some set limit, thus obviously understating depreciation allowances *currently,* to even up for too generous allowances *years ago.*

It appears to me that a contractor finding himself in this position with the Treasury is entitled to a fresh start when dealing with the War Department or the Navy Department. The costs determined for Government contracts may run but a short period relative to the lives of standard equipment converted to war use. The contractor is entitled to recover whatever is the actual cost due to wear and tear, obsolescence, and other factors during the period of his contract. If a contractor had written his property account down to one dollar, or if all of his property had become fully depreciated, there would be no question of his right to restate his property accounts in order to compute the depreciation sustained on the war work. By the same rule, he should be permitted a fresh start if his asset and depreciation reserves are materially out of line with the present useful condition of the property. Tax-wise, since income taxes appear to be here to stay, a taxpayer gets his depreciation either in one year or another, but the period of the war contracts will, we hope, not be sufficiently long to guarantee the contractor this protection.

Is accelerated depreciation an allowable expense element in war work?

T.D. 5000 provides, as an allowable element of cost, that, "In making allowances for depreciation, consideration shall be given to the number and length of shifts."

The E.P.F. and D.P.C. contracts for Government financing of plant facilities provide options to the contractors for purchasing the facilities at original cost less allowances for depreciation after the termination of the emergency. These option clauses quite uniformly state the following annual depreciation rates (which are higher than rates usually used under normal conditions) to be used in determining the recovery purchase prices under these contracts:

	Per Cent
Buildings and improvements	5
Machinery, equipment, furniture and fixtures	12
Portable and durable tools and automobiles	50

Section 8.2404 of the Navy Department regulations for the "Procurement of Naval Supplies" includes the following comment concerning accelerated depreciation as an element of the cost of supplies:

> Where plants are operating on two shifts, the depreciation rate may reasonably be 150 per cent of the normal rates for a single shift. Where the plant is operating on three shifts, the depreciation rate may be extended to 200 per cent of the normal rate.

Quite obviously, then, we have official sanction for the *principle* of accelerated depreciation.

Several points may well be borne in mind on this question:

1. The combined costs of maintenance and depreciation should be considered together. Excessive wear and tear may be made good during the accounting period by excessive expenditures for repairs and maintenance.

2. If the normal rates previously in use for the depreciation computations included a substantial allowance for obsolescence, supersession or inadequacy, a considerable amount of additional wear and tear may be experienced before any adjustment of the rate is in order. For example, if a machine could be used for 20 years on a wear and tear basis, but because we expected to want a larger or better machine in 10 years, we were using a 10 per cent rate instead of 5 per cent, then the machine can receive double the use without warranting any increase in the rate of depreciation. The 10 per cent rate then becomes 10 per cent for wear and tear rather than 5 per cent for wear and tear and 5 per cent for inadequacy, with no increase in the total charge to cost.

3. The same machines may have quite different life histories in the

hands of different owners. Some factors to be considered, other than the mere number of hours of machine use, are (1) the frequency of inspection of the condition of the machines, (2) the speed-up over the designed r.p.m., (3) possible overloading in excess of the designed load, (4) the use of unskilled operators, and (5) rapid deterioration when ordinary maintenance is omitted due to the pressure of production.

What about amortization as an element of cost? This question may be of great importance to a contractor if the emergency plant facilities have been provided with the contractor's own capital, particularly if he operates under a cost-plus-fixed-fee contract. It has been clearly shown to be a policy of the Government not to permit special amortization of emergency plant facilities as an element of cost. This policy was explained a year or more ago to be, (1) an effort to prevent inflation by keeping down the prices of the things the Government had to purchase that would be made in special war plant facilities, and (2) an effort to prevent alleged mistakes made in World War I, whereby the Government, by paying prices for supplies, which prices permitted the contractors to recover their capital investments, made so-called "gifts" to industry of valuable plant facilities.

The Administration developed the so-called tax-compromise idea, whereby contractors were permitted amortization for tax purposes, thereby recovering a part but not all of their capital investment through a reduction in taxes, but were not allowed recovery of special plant investment in excess of normal depreciation in the price of their products sold to the Government. This tax compromise was enacted into legislation in Section 124(i) of the Revenue Act of 1940, which required Certificates of Government Protection and Certificates of Non-Reimbursement to put teeth into the policy. This section proved, however, to be such a bottleneck to the war production program that it was repealed.

How does the situation stand today? Evidently we have fallen back upon the general provisions of law and Government contract regulations.

It should be recalled that prior to the advent of O.P.A., the War and Navy Departments considered amortization of special facilities a proper element of cost and they established a procedure for guaranteeing such protection by special negotiation. It is noted also that Section 8.2404(c) (8) of the Naval Regulations for the "Procurement of Naval Supplies" provides that amortization may be allowed as an element of cost where the purchases of special machinery and equipment have been approved in advance by the Navy.

The Treasury Department opposed the enactment of the amortization sections of the Internal Revenue Code on the argument that the ordinary depreciation, obsolescence and loss of useful value provisions gave the contractors ample right to recover the full costs of their investments for tax purposes. The difficulty there was that the deductions could be taken only *after* the event of the loss had taken place, and that current allowances to provide against the probability of the loss were denied. Treasury interpretations of the word "obsolescence" as an allowable element of cost under T.D. 5000 express the same view.

It is presumed that the auditors for Government contracts are still influenced by the same policy which brought about the enactment of Section 124(i). It may be that many contractors can recover all they consider necessary by means of accelerated depreciation. There may be instances, however (such as, for example, a shipyard constructed with private capital, the use of which for the entire period of the normal wear and tear life of the assets may be very problematical) where the actual cost to the contractor will not be determined unless an amortization allowance is included. The burden of proof, undoubtedly, will rest heavily upon the contractor; however, a claim should be made and a cost-plus-fixed-fee contract should not be closed until the facts are determined, even if it is necessary to hold the matter open until after the emergency to obtain a retroactive view of the facts.

Bases for the Distribution of Manufacturing Expenses: Section 26.9 of T.D. 5000 states that distribution on the basis of direct labor charges will be satisfactory, but that other bases may be used, depending upon "all the facts and circumstances." If better methods have been in use they should be continued. Special cost studies may frequently be required in order to produce evidence to the Government auditors that rates used for handling charges, floor space computations for departmental distributions, or power-plant schedules long in use are accurate under present operating conditions. The established methods may be sound in principle, but, in view of the frequent redepartmentalizations, reclassifications of expenses and conversions from commercial to war production, such established methods or schedules may very likely need review.

If the interpretations of direct and indirect labor are modified by the considerations previously discussed, the larger amounts classified as direct labor will require prompt reduction downward of normal departmental burden rates.

If service department costs (for example, power expense) has been distributed in two parts, (1) charges for fixed or stand-by costs allocated on a designed capacity or "ready for use" basis, and (2) charges for the variable factors of the service department costs—that is, the service actually used basis—there would appear to be every reason to continue this practice. The facilities inherited by the converted plant may bear little relation to the facilities that would be redesigned and installed today. Nevertheless, they are the actual facilities in use for the war production. The distribution of the total fixed service department plant investment costs should be revised according to present department utilization and the present machine requirements, but it would appear to me, under the actual cost theories, no segregation for capacity in excess of present needs would be required. In other words, the Government may have inherited a power plant which is not well designed or not economical for the use being made of it today, but the total actual costs may be applied.

"Reasonable" Expenses: Somewhere in every Government contract, there will be found the word "reasonable" in relation to allowable expenses. The interpretation of this word has been a shock to many executives. Apparently the interpretation is very different under a peacetime free enterprise, competitive economy, wherein a court may consider that compensation in excess of $1,000,000 a year is not unreasonable for top executives of a giant corporation, because of the competition for men of such caliber, as compared with a wartime, planned and "total-war" economy, under which citizens are being drafted regardless of personal abilities for military service at $21 per month.

I understand that the Navy and the Air Corps have established upper limits of $25,000 a year for executive salaries to be included in costs; that the Navy regards $9,000 a year as the top salary for field construction work; that the Ordnance Division of the Army requires special approval for salaries in excess of $12,000 a year; that bonuses are permissible only to the extent of 10 per cent upon salaries up to $3,000 a year, and that bonuses to executives are considered to be "not related to the contract" and "expenditures to be borne by the contractor out of his fees." Such limitations are not entirely new, as, I believe, the Merchant Marine Act of 1936 limited executive salaries, in the costs of contracts entered into by the Maritime Commission, to $25,000 a year.

We encounter similar interpretations of the word "reasonable" in the allowed per diem rates for traveling expenses. These rates, as permitted by the Air Corps, were $10 per diem for executives and $6 per diem for others, until late in 1941 when they were increased to $15 and $8, respectively.

The War and Navy Departments also insist upon the advantage of the Government rates (generally 60 per cent of commercial rates) on telegraph services. Each contractor must clarify his position with respect to this ruling. In certain instances, arrangements have been made to have separate invoices submitted by the telegraph companies for services on the Government contracts, and these invoices are paid directly by a Government Disbursing Officer after certification by the contractor, and they are thus excluded entirely from the contractor's accounts and costs. Under a Navy Department ruling, the 60 per cent limitation on telegrams applies only on "direct" charges and does not apply to telegrams included in "indirect" expenses prorated to a contract.

Contractors should protect their rights under their contracts in respect to all arbitrary limitations of expenses, by *written* protest or notice. In order to expedite current settlements, such excess expenses should be omitted from the expense distributions by segregation into an unallowable or Suspended Expenses Controlling Account, supported by detailed schedules for future reference. Needless to say, such controlling accounts should not be used in computations of inventory valuations, and they should be closed into the profit and loss accounts at each closing date. A permanent record should then be retained for future reference.

It is only fair to state that the Government, on cost-plus-fixed-fee work, does permit the inclusion of certain costs which a commercial customer might consider unreasonable; e.g., the cost of training employees in the necessary skills to perform their work, the cost of spoiled and wasted work, reworks, advances in labor and material costs due to general price trends, and other items which, under the theory of "actual cost," are directly related to the contracts.

"Personal" Expenses: The opinions of the Comptroller-General have disclosed a very restricted interpretation of the term "personal" expenses. For example, the cost of a chauffeur's license paid for an employee to permit him to drive in connection with his employment, the costs incurred by a contractor for employees while they were traveling on company business to assist them to obtain birth certificates required by federal regulations for admittance to other plants on business for their employers, and similar expenditures to assist them in filing questionnaires with draft boards, have been held to be personal to the employees and unrelated to the Government contracts, even for inclusion indirectly in general overhead expenses. It does not seem to me that a classification of "personal" expenses as unallowable expenses is sound, since the motivating force behind these expenditures, when made by the contractor, is the performance of the contract, and, moreover, Section 26.9 of T.D. 5000 specifically permits many "personal" expenses such as welfare expenses, pensions, traveling expenses, and, one might add, even pay rolls.

Contractors should not only reserve their legal rights by written notices to the contracting officers in connection with disallowances such as these, but they should make active protests, written and oral, so that interpretations may, if possible, be brought more into line with the usual business practices that were in the minds of the contracting parties when the contracts were signed.

CHAIRMAN WOOD: Thank you very much, Mr. Russell, for your very interesting talk. Are there any questions on either Mr. Russell's or Mr. Howell's talk?

MR. STARR: Mr. Chairman, I was just wondering what would be the proper handling of the increased labor cost, due to the rise of the cost of living index? Quite a few of the contracts have a basic labor rate as of a particular date, and to that they add the change in the cost of living index. Should that be a normal or an abnormal cost?

MR. RUSSELL: You refer, I suppose, to escalator clauses. There are several types of those contracts. Sometimes the increase is entirely unrelated to the contractor's own costs, but you refer to the case in which the escalator clause is tied up to the proof that the contractor suffered an increased cost. Personally, I don't think that requires special accounting treatment in pay roll and labor accounts; I think it does require statistical study, in order to arrive at a sufficient basis on which to convince the auditor that the statistical method, under the escalator clause, is sound; but I do not think that it calls for any segregation of a part of the pay roll into a special account.

Incidentally, I have heard a few interesting comments about that. One rumor is that the escalator clauses are generally to be renegotiated out of contracts; another is that, in inquiring as to the type of audit which the Government would require under an escalator clause, the answer was made that an escalator clause would require fully as detailed an audit as is required for the passing of public vouchers. If that should come about, the mere existence of an escalator clause in a fixed-price contract would be subjecting that contract to a complete audit by the Government auditors. That is one reason, I imagine, why they are contemplating taking them out.

MR. DAVERIO: Could you cite me a ruling by some authoritative source which approves a charge of some kind for use of fully depreciated items?

You said it might be well to give consideration to the fact that, because during former years we over-depreciated some of our assets, we ought to charge the Government for the use of those facilities which are now fully depreciated and which are now being used on Government contracts.

MR. RUSSELL: I don't think you will find any ruling from the Comptroller-General that will support that; the question is very much in the air at the present time.

MR. DAVERIO: Being tax-minded, my thinking runs this way: Suppose you attempt to charge the Government $10,000 for depreciation on fully depreciated assets under the cost-plus-fixed-fee contract, you pay your income tax on that particular income; if you are in the 95 per cent tax bracket, you pay 95 per cent to the Government in taxes, and retain only $500. The Comptroller-

General, three or four years from now, may say that the $10,000 charge was not a proper reimbursable cost item, and require you to refund that amount to the War Department. You would then have to file a claim for $9500 tax refund, which you may or may not be able to recover upon. It therefore seems to me you might be involved in a pretty dangerous situation unless you could get some kind of approval ahead of time. Maybe we shouldn't call it depreciation, maybe we ought to call it rent or some kind of item like that.

The thing that confuses me is that, even though the Government agrees to reimburse you for "costs," your books will not reflect any depreciation on fully depreciated assets.

MR. RUSSELL: I think you will have trouble unless there is a very marked differential. That is, I think if your books are far out of line that you should be able to get relief.

MR. DAVERIO: You can appreciate the danger.

MR. RUSSELL: Absolutely.

CHAIRMAN WOOD: I think you know, probably, that our accountant, who spoke here last year, has just about finished, I believe, and ready to issue, for the WPB, a new Regulation on Costs in Government Contracts. It is not intended directly to supersede T.D. 5000, but I am sure it will have an important bearing on it.

DR. TAGGART: I may say that it is just off the press; I received my first copy the day before I came here.

CHAIRMAN WOOD: Have you any comment that you could give us on that, Dr. Taggart?

DR. TAGGART: The only comment I have is that it is very carefully drawn to agree with T.D. 5000, down to the last dot of an i and cross of a t; it is simply what you might call an expansion or explanation of T.D. 5000; it has been passed around to all the Departments of the Government which might conceivably be interested, and they have all gone over it with a fine-tooth comb, and I think it probably will be a thoroughly reliable guide to the contractor. However, whether the Treasury Department will agree to be bound by it, I hesitate to say.

CHAIRMAN WOOD: I have one question I would like to ask, Mr. Russell. Did I understand you to say that your cost on your regular commercial work should not be reduced because of the increased volume of work that is being done by the plant as a whole?

MR. RUSSELL: I said that it would be very dangerous if such a reduction found its way into the price structure of the commercial product, from the standpoint of the situation in industry after the termination of the emergency, and that the volume variance resulting in the commercial work really belonged to the contractor.

CHAIRMAN WOOD: That is a debatable point, I am afraid.

Are there any more questions?

QUESTION: Mr. Howell referred to a Bulletin of May in his talk. Is that a National Association of Cost Accountants Bulletin?

CHAIRMAN WOOD: Yes, for May, 1942, I believe.

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